

# **Charges in South African retirement funds**

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National Treasury

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# 1. Introduction

This paper is one of a series of technical discussion papers to promote household savings and reform the retirement industry. It follows on from the 2012 and 2013 Budget announcements by the Minister of Finance, and the overview papers *Strengthening Retirement Savings* (14 May 2013) and *2013 Retirement reform proposals for further consultation* (27 February 2013). Four other technical discussion papers on retirement reform were released over 2012, including:

B. *Enabling a better retirement income* – Reviews retirement income markets and measures to ensure that cost-effective, standardised and easily accessible products are available to the public.

C. *Preservation, portability and uniform access to retirement savings* – Gives consideration to phasing in preservation on job changes and divorce settlement orders, and harmonising annuitisation requirements. The aim is to strengthen retirement provisioning, long-term savings and fund governance.

D. *Incentivising non-retirement savings* – Discusses how short- to medium-term savings can be enhanced, and dependency on excessive credit reduced, through tax-preferred individual savings and investment accounts. It also discusses the design of incentives to encourage savings in lower-income households.

E. *Simplifying the tax treatment of retirement savings* – Proposes harmonising tax treatment for contributions to retirement funds to simplify the tax regime around retirement fund contributions.

All these papers are available on the National Treasury website [www.treasury.gov.za](http://www.treasury.gov.za).

This paper, *Charges in South African Retirement Funds*<sup>1</sup> presents an overview, based on the information available to National Treasury, of the current level of charges during the accumulation phase (i.e. before retirement) in South African retirement funds, provides an international comparison, and examines the drivers of observed charge levels. Several possible draft options for reform are presented. It is not the goal of this paper to propose any particular approach. Rather, it is intended to facilitate engagement with retirement funds, service providers and other stakeholders, as well as to promote public consultations on how the charges of retirement funds can be reduced during the accumulation phase. The ultimate intention of the paper is to assist South Africans in getting the best possible value for the retirement savings they make.

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<sup>1</sup> In the overview paper, this paper A was initially referred to as "Retirement fund costs", but has been re-named to take account of the content.

## ■ Executive Summary

The level of costs and charges is a significant factor in determining the benefits a retirement fund member will receive in return for the contributions that were made to the fund. This paper presents an overview of the current level of charges during the accumulation phase (i.e. before retirement) in South African retirement funds, provides an international comparison, and examines the drivers of observed charge levels.

Major determinants of the level of charges are structural: the industry is fragmented, with approximately 3000 active retirement funds, most of which are small, membership in the system is voluntary, with only around half of formally-employed workers participating, and balances are low, partly because few members preserve their funds for retirement.

### The distinction between costs and charges

*Funds incur costs which are recovered from members through charges*

Retirement funds of all types need to perform various functions. These may include distributing the fund to members and prospective members, providing financial advice to members, administering the fund and the benefits, providing risk benefits, and managing and administering investments. To perform each of these functions, the fund incurs expenses, which, if they occur on a fund level, are called 'costs' for the purposes of this paper.

To cover these expenses, funds deduct monies from contributions or sell fund assets, reducing the value of members' interest in the fund. These deductions, which occur at a member level, are called 'charges' for the purposes of this paper.

Most funds recover all of their costs by levying charges on members (although some employers may contribute towards the cost of running employer-related funds directly, or indirectly by performing services on behalf of the fund).

In practice, it is extremely uncommon for the charges to be recovered from members in a way which exactly matches the incurred costs of a fund.

### Examples of retirement fund costs

Typically, South African retirement funds perform several functions. Individual members must know about the fund, and must join it, and may receive financial advice before they do so. Funds must be administered, pay for risk benefits and manage investments. These functions are summarised for the different retirement funding channels in Box 1 below.

### Determinants of retirement fund costs

*The main determinants of the costs of retirement funds*

The main factors determining the cost of retirement funds include:

- *The size of the fund.* Significant fixed costs of running a fund, and economies of scale in fund administration and investment management mean that funds with more members and greater

assets under management typically have lower costs per member or per unit of assets than smaller funds.

- *Degree of preservation.* Systems with a greater degree of preservation accumulate more assets per member, all else being equal, and are therefore cheaper per unit of assets invested. The fact that rates of preservation in South Africa are low therefore implies that costs will be higher than they could otherwise be.

**Box 1: Summary of interaction between fund functions and retirement savings channels**

	<b>Distribution and financial advice</b>	<b>Administration</b>	<b>Risk benefits</b>	<b>Investment management</b>
<b>Stand-alone and non-commercial umbrella funds</b>	Automatic distribution through employers; financial advice not usually given	Purchased in group market by trustees, usually under advice from consultants	Purchased in group market by trustees, usually under advice from consultants	Purchased in group market by trustees usually under advice from consultants; some funds may offer member choice
<b>Commercial umbrella funds</b>	Distribution to employers through brokers, who may provide financial advice to groups of employees; mandatory membership for employees.	Fund selected by employer or management committee of sub-fund	Purchased in group market, usually separately for each participating employer; risk benefit design often customised	Options selected by trustees; selection made by employer and/or trustees of sub-fund; some sub-funds may offer member choice
<b>Retirement annuity and preservation funds</b>	Agents and brokers distribute and may provide individual financial advice	Fund selected by individual member	Risk benefits not usually part of these funds & may be purchased separately in individual market	Options selected by trustees; individual member usually exercises choice

- *Extent of compulsion.* Whether the fund or system is mandatory or voluntary. Generally employer, union, bargaining council and sectoral determination funds are mandatory once a fund has been set up. Retirement annuity funds and commercial umbrella funds need to be marketed and sold to prospective clients, who may be individuals or employers, adding to their cost, and with implications for their design.
- *Degree of subsidy.* Whether some fund functions are centralised or subsidised. It is not uncommon for employers to subsidise some plan functions, and in some countries, but not in South Africa, a centralised clearing house performs many plan functions.
- *Level and cost of risk benefits.* The level and cost of risk benefits, which are particularly important in South Africa. Funds with high numbers of lower-paid workers have much higher risk benefit costs than funds with higher-paid workers, reflecting higher probabilities of death and disability.

- *How assets are invested.* Plans which invest in fixed-interest instruments usually have much lower costs than those which invest in equities. Passive investment is usually cheaper than active investment. Investment in alternative asset classes (property, private equity, hedge funds) may be more costly. Return guarantees are costly to provide.
- *Functions performed.* These may include the extent of individual financial advice provided by the fund, the degree to which individuals or employers can customize the fund's investment strategies, or their risk benefits in relation to individuals or groups of members, and the degree of discretion given to trustees in exercising their duties. Compliance with regulation is costly, but regulation also provides direct and indirect benefits to members.
- *Quality of services.* Differences in the quality of service to members. Providing a higher quality of service, a greater level of financial soundness, and utilising a greater degree of skill in investment management is more costly.

### Examples of retirement fund charges

*Types of different charges levied on members*

Charges paid by members of retirement funds depend on the design and type of fund. Members of non-commercial funds that do not offer investment choice may pay only one charge based on a level proportion of contributions or payroll, and one charge based on a level proportion of fund assets.

Members of commercial umbrella funds or retirement annuity funds may pay a much greater range of charges, especially if funds offer investment choice. These charges may include administration charges, policy fees, benefit consulting charges, financial advisor fees, risk charges, asset management charges, manager selection charges, guarantee charges, capital charges, performance fees, platform fees, and conditional charges when various events, such as switching investments, leaving the plan, or terminating the policy, occur.

*Types of different bases upon which charges are levied*

Most of these charges are levied either as a percentage of salary or contributions, or a percentage of assets under management. Some are levied as a percentage of returns, possibly above a benchmark, some may be a fixed rand cost each year per member or per employer.

### Drivers of retirement fund charges

*Different forms of fund governance have a substantial effect on the charging basis used by funds*

Retirement fund charges depend heavily on the governance structure of the retirement fund, since this affects the relationship between the fund, the member and service providers, and how funds conduct themselves. Conflicts of interest may have a greater effect on retirement outcomes in some governance structures than in others. For the purposes of this paper, South African retirement funds are divided into three groups:

- Non-commercial employer-based retirement funds, union funds and non-commercial umbrella funds. These are retirement

funds set up by employers, unions and bargaining councils for the benefit of their members and employees. They are run on a non-commercial basis.

- Commercial umbrella funds. These are multi-employer retirement funds set up by a financial services provider in order to facilitate demand for its services and those of related entities. These funds are marketed largely to employers. To enjoy tax advantages, membership of the fund may be made mandatory if employers participate.
- Retirement annuity funds and preservation funds. These are mostly set up by commercial sponsors in order to facilitate demand for their services, but are marketed directly to individuals who voluntarily join the funds. Employers are generally not involved.

Other than the governance of the fund, important factors which may affect the charging structure of a retirement fund are:

- *The cost basis of the fund.* In a competitive market, there should be a close match between the costs incurred by a fund and the charges levied. However, various factors described below may influence the charging basis, causing it to deviate from the cost basis of the fund.
- *The regulatory structure underlying charges.* Many countries regulate the type, size or number of charges retirement funds may levy. In South Africa, besides maximum commission scales, there is no regulation on either the type or size of fees which may be charged by retirement funds. This is a common feature of Anglo-Saxon-type retirement systems, broadly shared by the UK, Ireland, Australia and the US.
- *The degree to which charging structures are redistributive.* In South Africa, charging structures are often (voluntarily) redistributive, with higher income earners subsidising the costs of membership for lower income earners.
- *The price sensitivity of customers.* Since charges do not affect member cash flow but translate into lower benefits, which may only be received many years in the future, customers may not be very sensitive to the overall level of charges in their retirement funds. Customers may also be more sensitive to initial charges, and less sensitive to apparently smaller recurring charges.
- *The degree of market intermediation.* Charges should ideally be sufficiently simple to communicate to customers. However, if service providers sell through intermediaries, they may be able to increase the complexity of charging structures as well as the average level of charges without deterring customers.
- *The degree of market competition.* Requirements for competitive markets include, but are not limited to: transparency of charges and product terms, comparability and

*Other factors which also influence the charging basis*

portability of products between providers, financially informed and active consumers and low barriers to entry and exit by sponsors.

- *Product diversity.* If products are hard to compare, then providers may be able to raise charges. Product complexity may therefore facilitate higher charges. It may also allow providers to practise various forms of price discrimination.
- *The degree of disclosure.* Some charges may be netted off investment returns, and therefore not disclosed, and some may be disguised in other forms, such as performance fees or charges for guarantees. Further, some implicit costs of investment management – such as brokerage, bid-offer spreads, and Securities Transfer Tax – may not be disclosed at all.

### **Measuring and comparing charges**

*Different summary measures of the overall effect of charges on consumers*

Since there are so many different types of charges, in order to compare the effect of charges on policyholder or member outcomes, a standardised measure of charges is required. Various measures are possible, all of which are in common use. Two forward-looking measures estimate the effect of charges on either the reduction in the rate of return enjoyed by the policyholder caused by charges over the life of the policy (called the Reduction in Yield, *RiY*), or on the maturity value of the contract (called the Reduction in Maturity Value, *RiMV*).

Two other measures examine the effect of charges in a particular year, either as a proportion of fund assets (Accounting Cost per fund assets, *ACA*, similar to the Total Expense Ratio or *TER*) or as a rand amount per member per month (Accounting Cost per member, *ACM*).

All four of these measures struggle to reflect accurately the impact of conditional charges such as guarantee charges, performance fees or surrender charges. The measures and the relationship between them are discussed in more detail in Appendix A.

### **Disclosure of charges**

*In compulsory membership group schemes, there is currently no regulation requiring the disclosure of charges to members.*

In compulsory membership group funds, there is currently no regulation requiring the regular disclosure of charges to fund members, although PF130, a non-binding circular issued by the Registrar of Pension Funds, does recommend some types of disclosure. As part of its Treating Customers Fairly initiative the FSB is considering whether the registrar should issue a directive requiring specific disclosures by Boards of management to fund members.

The Financial Advisory and Intermediary Services Act (FAIS) of 2002 requires that disclosures of charges be made by financial advisors when advising on financial products accessible through retirement funds. The Long Term Insurance Act (LTIA) requires underwritten retirement annuity funds to report to their members the charges levied against premiums, other than the implicit costs of

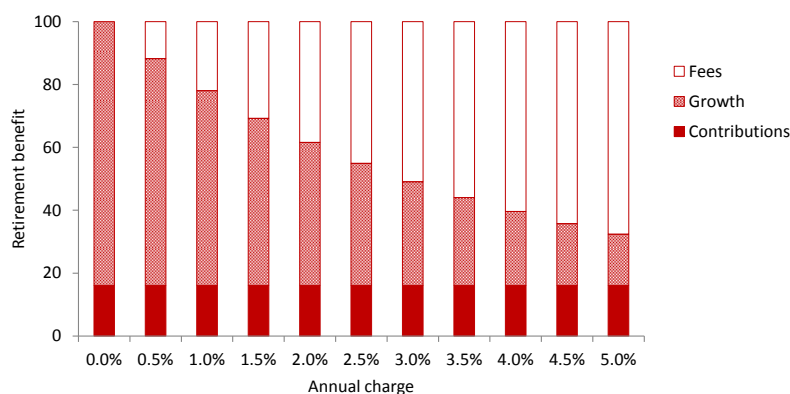


investment management, and to summarise these charges in the form of a *RiY*.

### The effect of charges on retirement benefits

In a DC system, charges are likely to be shared between employees and employers. Recurring charges levied by retirement funds on assets under management are generally borne by individual members in the form of lower benefits when they retire, while in employer-based DC funds, initial charges – charges expressed as a portion of contributions or payroll – are usually borne by employers.

**Figure 1: Effect of recurring charges on retirement fund accumulations after 40 years**



Source: Treasury modelling. Model assumes annual contributions increasing in line with wages over 40 years. Results are not sensitive to investment returns.

Recurring fees have a particularly significant effect on the retirement benefits individuals receive. For instance, as shown in Figure 1, a regular saver who reduces the charges on his retirement account from 2.5 per cent of assets each year to 0.5 per cent of assets annually would receive a benefit 60 per cent greater at retirement after 40 years, all else being equal.<sup>2</sup> Alternatively, he could get the same retirement benefit by making contributions over his lifetime that are around 40 per cent lower.

*Apparently small annual recurring fees have a substantial effect on retirement fund outcomes*

### Charges in the South African retirement system

Table 1 compares various measures of charges for different types of retirement fund in South Africa. *RiY* and *RiMV* are measured over 20 years, except in the case of Gluckman and Esterhuyzen (2011)'s analysis of one umbrella fund, where an average of fund members was used. As with all long-term prospective calculations, strong assumptions, which are described in more detail in the text, underlie the figures in this table.

Although international comparisons are difficult for the reasons summarised on pages 4-7 and 54-55, it is useful to place these

<sup>2</sup> These results assume regular contributions increasing at 6 per cent per year for 40 years. Although investment returns were assumed to be 10 per cent each year, the results are relatively insensitive to the level of asset returns in the fund.

estimated charges of different parts of the South African system in an international context, as is done in Figure 2. The figure shows the annual *RiY* over 40 years for various types of retirement funds and various retirement systems across the world.

**Table 1: Estimated 20-year *RiY/ACA* and *RiMV* for different South African retirement funding channels.**

	<i>RiY/ACA</i> §	<i>RiMV</i>	Notes
<b>Large stand-alone funds</b>	0.99% p.a. (Davies)§ 1.04% p.a. – 1.65% p.a. (Rusconi)§ 1.03% p.a. (G&E)	~10% (Davies)* ~10% - 17% (Rusconi)* 12.75% (G&E)	These estimates may understate costs because employers may bear some fund costs themselves.
<b>Commercial umbrella funds</b>	2.03% p.a. (Davies)§ 1.90% p.a. (G&E) 1.65% p.a. (G)	~20% (Davies)* 18.68% (G&E)	G&E and G exclude very low-income individuals from their sample and exclude guarantee charges. Value refers to average <i>RiY</i> across members with varying terms to retirement.
<b>Retirement annuity funds</b>	3.51% p.a. (R, R200p.m.) 3.05% p.a. (R, R1 000 p.m.)	28.4% (R, R200 p.m.) 25.75% (R, R1 000 p.m.)	These are 'old generation' RA contracts. Figures exclude additional early surrender penalties, which may be substantial.
	3.60% p.a. (G&E, R600 p.m.) 3.40% p.a. (G&E, R1500 p.m.)	~36% (G&E, R600 p.m.)* ~34% (G&E, R1 500 p.m.)*	
	~2.3%*	22.6%	This is an average across four providers for 'new-generation' RA contracts, details shown in Table 5

\* These values are calculated using the approximate relationship between *RiY* and *RiMV* shown in the text, assuming an average term of 20 years.

§ Numbers indicated by this symbol are ACA-type measures rather than Reductions in Yield. See the Appendix for a description of the conditions under which these are comparable.

Source: Davies (2011), Gluckman and Esterhuyzen (2011), Gluckman (2013) and Rusconi (2004), Treasury calculations.

### Draft findings

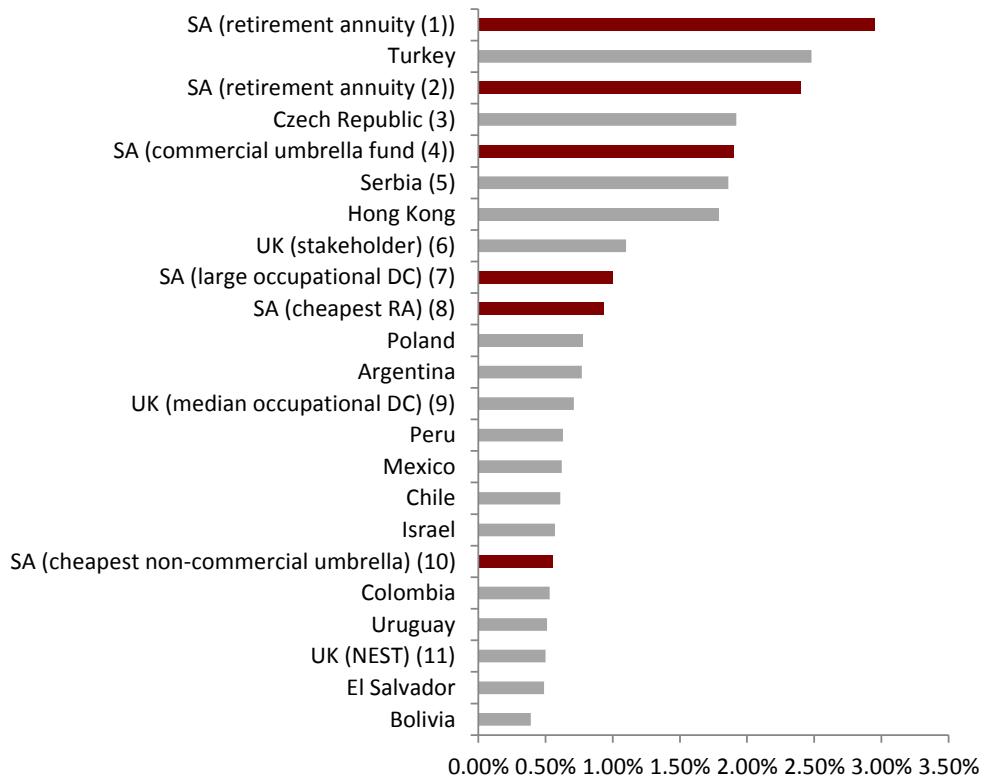
The following are the main draft findings of this report:

*At least partly due to structural factors, the South African retirement system appears expensive*

- Structural factors – including the large number of retirement funds, the voluntary nature of the system, which has implications for design, cost and complexity, and the low rate of preservation in South Africa – are significant drivers of the costs of the South African retirement system, which appears to be expensive in an international context. Higher rates of preservation, a smaller number of funds, and greater participation in the system, if well managed and regulated, could lower costs. The level, and quality, of employment will also affect coverage, and hence the level of costs.
- Charges vary between funds of different types, both in terms of the overall level of fees and in their complexity. The charge

structures of funds that are established to sell the services of their commercial sponsors and related parties are often exceptionally complex, making different types of plan and different options within each plan very hard to compare.

**Figure 2: Estimated 40-year annual *RiY* for various South African plan types in an international context**



Source: Hernandez and Stewart (2008), unless otherwise indicated. International comparisons are difficult for many reasons, see text for details. All figures probably exclude trading costs.

- (1) Old-generation providers, from Gluckman & Esterhuyzen (2011). Figures exclude additional early surrender penalties which may be substantial.
- (2) Average of four new-generation providers, Treasury analysis. Charging structures assumed unchanged over 40 years in nominal terms.
- (3) Voluntary system, figure includes cost of return guarantees.
- (4) Gluckman & Esterhuyzen (2011), average *RiY* figure, excludes the cost of return guarantees in smoothed bonus portfolios. Gluckman (2013) reports lower average *RiY* in 2013 for the same fund.
- (5) A voluntary system established one year before 2008 paper written.
- (6) Whitehouse (2000).
- (7) Rusconi (2004); Gluckman and Esterhuyzen (2011), ACA-based measure.
- (8) Cheapest new-generation RA of four examined. Charging structures assumed unchanged over 40 years in nominal terms.
- (9) Department for Work and Pensions (2012).
- (10) Industry fund with relatively few participating employers. Some degree of employer subsidy likely.
- (11) [www.nestpensions.org.uk](http://www.nestpensions.org.uk)

*Fee disclosure is low in stand-alone funds and umbrella funds*

- The level of fee disclosure to members in stand-alone retirement funds and umbrella funds of all types is low, and in smaller or less-well-run funds, charges may be high. Yet members are automatically enrolled into these funds as a condition of employment. However, increased disclosure is unlikely to be sufficient on its own to achieve lower costs.

*There is a tendency to shift charges away from initial charges and towards recurring charges*

- There appears to be a broad tendency in retirement funds to shift away from up-front charges based on contributions, to recurring charges expressed as a proportion of assets under management. Recurring charges may be less visible to clients than initial charges for a variety of reasons.

*Recurring charges are also shifted between different types of charge*

- Recurring charges themselves may also be shifted between asset management charges, performance fees, guarantee charges, platform fees, administration fees and advisor fees in order to make the overall level of charges appear more palatable to consumers. Shifting may be implicit, or achieved through the payment of rebates.

*Active investment management may unnecessarily drive up costs*

- A preference for active management on the part of consumers and intermediaries may mean that the fees for investment management are significantly higher than the lowest attainable levels, particularly for retail investors.

*Intermediation may inadvertently raise complexity and cost*

- Financial intermediaries, including retail agents and brokers, wholesale brokers, advisors and investment platforms, play a valuable role in bringing buyers and sellers of services together, and in some cases by providing financial advice in order to improve financial decision-making. However, intermediation of all types may have the unintended consequence of raising the complexity of retirement fund designs as well as their cost.

*Investment platforms create layered charging structures, and may be conflicted between buyer and seller, leading to higher costs*

- Investment platforms provide valuable services to members and investment managers. However, the layered charging structures they create add complexity as well as cost to retirement funds. The payment of rebates between investment managers, platforms, and possibly other intermediaries creates conflicts of interest whose effect may be to raise the overall level of charges paid by consumers. In some cases, consumers may even be paying twice or three times for the same services.

## **Draft Proposals**

The proposed draft reforms can be divided into the following broad themes. More detailed draft proposals may be found in each chapter.

### *Encouraging fund consolidation*

*Fund consolidation should be encouraged*

Most existing retirement funds do not have the necessary size to achieve sufficient economies of scale, which leads to higher costs and lower benefits for members. Achieving sufficient economies of scale while retaining distribution through the workplace will require a broad move towards multi-employer arrangements.

### *Improving fund governance*

Although the process of strengthening fund governance has already started with amendments to the PFA in 2013, more needs to be done. For instance the act, or a directive issued in terms of the act, may make explicit the duties of Board members in regard to the fund and the members, and require them to ensure that funds fulfil their objectives cost-effectively. The law may also be changed to increase the requirement for boards to have independent and expert trustees, to require employer and member-elected trustees on the boards of all multi-employer funds along the lines of the King III governance principles, and to formalise the role, rights and obligations of employer-level committees in such funds.

*Fund governance, particularly umbrella funds, should be strengthened*

### *Strengthening fund regulation*

A strong and effective regulator is essential in ensuring a well-functioning retirement system. The regulator needs to have the power to effectively monitor all aspects of the retirement system, including costs, and the power to intervene where necessary to protect the interests of members. These powers will be conferred by statute as part of the move to twin peaks financial regulation, and will be aided by an acceleration of the consolidation of funds. The regulator may consider issuing standardised documents, such as fund rules, investment mandates, service-level agreements, and codes of practice for the use of funds.

*Fund regulation should be strengthened*

### *Retaining the role of the workplace*

Given the higher costs associated with individually-distributed arrangements, and the low degree of financial sophistication of the South African workforce, it is recommended that the primary place where retirement savings products are distributed remain the workplace. Reliance should be placed on reforming fund governance, and, where appropriate, design, in order to ensure that members' interests are protected and that tax incentives granted to members who save for retirement are used appropriately for their benefit.

*The role of the workplace should be retained*

### *Simplifying plan design*

In order to increase competition based on price, a significant simplification of the design of retirement products permitted to qualify for tax exemption is proposed. This may imply a standardisation of permitted charging structures, a requirement that all fund members be charged on the same basis, and a restriction on the investment options, if any, which all funds may offer their members, to those compliant with prescribed standards. Volume discounts, either at employer or employee level, may be permitted. Performance fees, in particular, will be examined closely. Retirement funds which grant member investment choice may be required to have suitable default investment portfolios, which must meet more stringent requirements, including an outright ban on any exit penalties or loyalty bonuses, and possibly a cap on recurring

*Plan designs should be standardised as far as possible*

charges. This is intended to limit the ability of providers to shift charges onto recurring charges.

#### *Ensuring effective intermediation*

*Intermediaries in the group space should be remunerated in a way which aligns their interests with those of customers*

While intermediation of all types is important, it can be expensive, and may be conflicted by remuneration structures. Work is currently underway in the retail space to explore ways in which the remuneration of intermediaries may better align their incentives with customers. This review will be expanded to include intermediary remuneration in the group retirement space. Various aspects of investment platforms, including the payment of rebates by investment managers to platform providers, will be also be investigated.

#### *Mandating enrolment into retirement funds*

*Mandating participation in a retirement fund should be considered for all workers*

A significant driver of the cost of private funds is the need to distribute them to individuals. To reduce these costs, one option may be to require employers to automatically enrol their employees into a retirement fund, which may be a stand-alone pension fund, an umbrella fund, or a retirement annuity fund.

#### *Creating a retirement fund exchange or clearing house*

*A centralised clearing house could significantly reduce the overall level of administration and distribution costs*

One option to ensure that auto-enrolment is effectively implemented, may be to create an exchange that allows smaller employers and their employees to compare different plans easily, and to choose one which meets their needs, without their requiring financial advice. Funds which satisfy certain criteria, including scale, design, efficiency and simplicity will be permitted to list on the exchange. Further cost reductions may be obtained through allowing the exchange to operate as a clearing house, centralising contribution collection and possibly fund administration, and automating the process of switching between plans. The clearing house or exchange may be integrated with the SARS tax collection system, as in the case of the KiwiSaver program in New Zealand.

#### *Establishing a default fund*

*A default fund or funds should be established to ease auto-enrolment*

Another requirement for effective auto-enrolment is that there be a default fund for those employers who do not specify a fund themselves. One option for this may be a specific fund or funds set up for this purpose, to be regulated under the PFA and listed on the exchange. These funds may also serve other functions, such as facilitating preservation and ensuring the effective management of unclaimed benefits.

## 2. Background

South Africa has moved from a largely defined benefit (DB) retirement system, to a largely defined contribution (DC) system over the last 25 years. By many measures, the retirement system is a great success. Participation rates and contribution rates are high even relative to countries with ostensibly mandatory systems, and the quantity of the system's assets under management is one of the highest relative to GDP in the world. All this is despite the fact that although retirement provision is tax-preferred for employees in South Africa, it is largely voluntary for employers.

*The South African retirement system has high coverage and is relatively mature*

However, other than restrictions imposed through the tax system, South Africa has relied almost entirely on the market mechanism to determine benefit design and fee structures. As a result, the system has attained a bewildering degree of complexity. To some extent this may be a legislative and market response to the highly heterogeneous population of South Africa. But it may also be evidence of a market which is emphasising product differentiation at the expense of price competition. Greater product differentiation makes charges less transparent and prevents accurate comparisons across products.

*The system has relied entirely on the market system to determine plan design and charges*

There has been concern in many quarters for some years about the high level of charges in the South African retirement industry. In DC systems, especially funded DC systems such as South Africa's, the level of costs has a significant effect on the benefits that individuals receive. High charges may impede the efficacy and efficiency of the retirement system with potentially significant long-run consequences for its design.

*Charges, however, are high relative to international benchmarks*

Further, the expressed intention of Government to create a national social security system, in which approved – largely DC – funds will play a very significant role means that it is imperative to examine charges, and the policy options available to reduce them, in order to chart a fair, achievable and durable course into the future.

*Charges must be reduced as far as possible*

### ■ The South African retirement landscape

The legislative basis of the bulk of the retirement system is the Pension Funds Act (PFA), 1956, as amended, and the Income Tax Act (ITA), 1962, as amended. All retirement vehicles in South Africa, with few exceptions (largely in the public and state entity sectors), are regulated under these two acts.

*The legislative basis of the retirement system rests in the PFA, 1956, and the ITA, 1962*

All retirement funds – whether group, individual, single or multi-employer – are set up as legal entities separate from their sponsors and participating employers. However, there is a large variety of different types of funds, which are listed in Box 1. These funds differ in two important respects.

The tax treatment of contributions, investment income and benefits, and annuitisation requirements depend on whether the fund is classed as a pension fund, a provident fund, or a retirement annuity fund for the purposes of the ITA. A process is currently underway

to harmonise the tax treatment of the three types of fund in the ITA to significantly reduce the complexity of the retirement system.

Secondly, the extent of employer involvement differs between various types of all three vehicles. This has important consequences because it influences the style of operation of the fund – such as whether and how it needs to be marketed, its implicit profit motive, and its governance. This distinction is largely codified in the PFA. A typology is shown in Box 2.

**Box 2: Main types of South African retirement funds**

	<b>Compulsory membership group arrangements</b>		<b>Voluntary membership individual arrangements *</b>
	<b>Non-commercial funds</b>	<b>Commercial funds</b>	<b>Commercial funds</b>
<b>Pension funds</b>	Standalone employer pension fund, bargaining council fund, industry fund, union fund.	Umbrella fund	Pension preservation fund
<b>Provident funds</b>	Standalone employer provident fund, bargaining council fund, industry fund, union fund	Umbrella fund	Provident preservation fund
<b>Retirement annuity funds</b>		‘Group’ retirement annuity funds	Individual retirement annuity funds

\* Even though these are marketed to individuals, and hence called voluntary membership individual arrangements, members will almost always join a single large fund with many members.

*Various governance structures of retirement funds*

In this table, funds have been divided by their governance structure and tax treatment.

All retirement funds registered in terms of the PFA are ‘not-for-profit’ entities in that, in terms of section 10 of that act, their only permissible ‘business’ is the provision of retirement and related benefits for members and other beneficiaries. Some funds are, however, ‘captured clients’ established by financial services or product providers (such as fund administrators, insurers or asset managers) and governed and operated in a manner intended to generate profit for service and product providers related those sponsors. For this reason they are referred to in this paper as ‘commercial’ funds. ‘Commercial funds’ include:

- multi-employer funds marketed to employers unrelated to other participating employers and for whose employees, or categories of employees, membership of the funds are compulsory for tax reasons, called commercial umbrella funds; and
- retirement annuity funds (RAF’s) and preservation funds (which may be pension or provident funds for tax purposes), membership of which is voluntary and which are thus marketed to individuals.

These may be contrasted with non-commercial funds, such as those established by employers for the benefit of their staff, by unions for the benefit of their members, and by bargaining councils for the benefit of employees subject to the terms of collective agreements



concluded in those councils. These funds select and appoint providers of products and services to them on a ‘pure procurement’ or ‘arm’s-length’ basis.

**Box 3: Summary of active retirement funds, by fund governance type.**

Assets under management	Group		Individual	Total
	Non-commercial funds	Commercial umbrella funds	Retirement annuity and preservation funds	
DB Pension and Provident funds	R343bn	R4bn	R2bn	R349bn
DC Pension and Provident funds	R549bn	R103bn	R72bn	R725bn
Retirement Annuity funds	-	-*	R264bn	R264bn
<b>Total</b>	<b>R892bn</b>	<b>R107bn</b>	<b>R338bn</b>	<b>R1 337bn</b>

Members	Group		Individual	Total
	Non-commercial funds	Commercial umbrella funds	Retirement annuity and preservation funds	
DB Pension and Provident funds	2 117 715	18 106	3 705	2 139 526
DC Pension and Provident funds	4 756 495	1 340 165	213 929	6 312 966
Retirement Annuity funds	-	-*	3 818 438	3 818 438
<b>Total</b>	<b>6 874 210</b>	<b>1 358 271</b>	<b>4 036 072</b>	<b>12 268 553</b>

Assets per member	Group		Individual	Total
	Non-commercial funds	Commercial umbrella funds	Retirement annuity and preservation funds	
DB Pension and Provident funds	R161 975	R223 506	R444 567	R162 985
DC Pension and Provident funds	R115 495	R76 816	R335 381	R114 815
Retirement Annuity funds	-	-*	R69 205	R69 205
<b>Overall</b>	<b>R129 814</b>	<b>R78 771</b>	<b>R83 658</b>	<b>R108 797</b>

\* ‘Group’ retirement annuity funds are shown under the ‘individual’ column as this is how the data are reported by the FSB.

Source: FSB

Data was obtained from the FSB website<sup>3</sup> to estimate the relative importance of these different types of fund. The data are summarised in Box 3 for normal ‘active’ funds (rather than orphan funds or those undergoing liquidation). Since the tax treatment of funds is not relevant here, pension and provident funds are grouped together, and results are shown separately for pure DC and DB funds (hybrid funds were accounted for with the DB funds).

Because individuals may be members of multiple funds, and because the source of these data is the latest fund accounts submitted to the FSB – which may refer to different dates, results can only be regarded as indicative. For instance, estimates based on Quarterly Labour Force Survey data from the third quarter of 2010 suggest that the total number of individuals in the South African retirement system is somewhere around 6 million, reflecting significant double counting in the above table. This double-counting represents a source of inefficiency, since it implies that many individuals

<sup>3</sup> [http://www.fsb.co.za/HTML/Pensions/Reports/Active\\_Employers.zip](http://www.fsb.co.za/HTML/Pensions/Reports/Active_Employers.zip), accessed 6th December 2011.

maintain more than one account in the system, potentially increasing costs.

These figures also exclude retirement funds not supervised by the FSB, including the Government Employees Pension Fund, a DB fund with around 1.3 million members and assets under management of approximately R1trn.

Non-commercial funds manage about two-thirds of the assets in the universe being considered; if DB funds are excluded, this falls to around 55%. Commercial funds are dominated by voluntary membership funds – in particular retirement annuity funds. Commercial, compulsory membership funds – the umbrella funds – manage only 7% of the total assets in the fund universe, although this is expected to grow substantially in the future.

Since most employed South Africans are members of DC funds rather than DB funds, and because it is expected that the DC system will become even more dominant in future, this paper will focus on charges in DC retirement funds. However, many of the issues raised are also relevant to DB retirement funds.

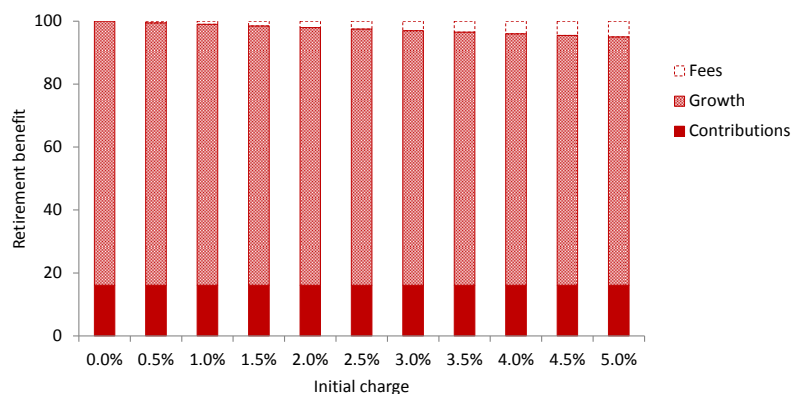
### Who bears retirement fund charges?

*Recurring charges are borne by employees in the form of lower benefits; initial charges are more likely to be borne by employers*

The importance of charges in retirement funds lies in the effect that they have on the final retirement benefits received. In South Africa’s retirement system, recurring charges, which serve to reduce the investment return of the fund, are borne entirely by members in the form of lower benefits when they retire. Initial charges (those charges deducted from contributions made to the funds) are more likely to be borne by employers.

*Initial charges have little impact on retirement benefits*

**Figure 3: Effect of initial charges on retirement fund accumulations after 40 years for a regular contributor**



Source: Treasury modelling. Model assumes annual contributions increasing in line with wages over 40 years. Results are not sensitive to investment returns.

Figure 3 shows the effect that initial charges have on the final benefit received for a regular saver in a retirement fund over a period of 40 years. Initial charges vary from zero to five per cent along the horizontal axis. The vertical axis shows the final retirement benefit, re-scaled so that, in the case of no initial fees, the benefit equals 100. The amount of the benefit is divided into that part representing

accumulated contributions and that part representing the growth in the value of those contributions net of initial charges.

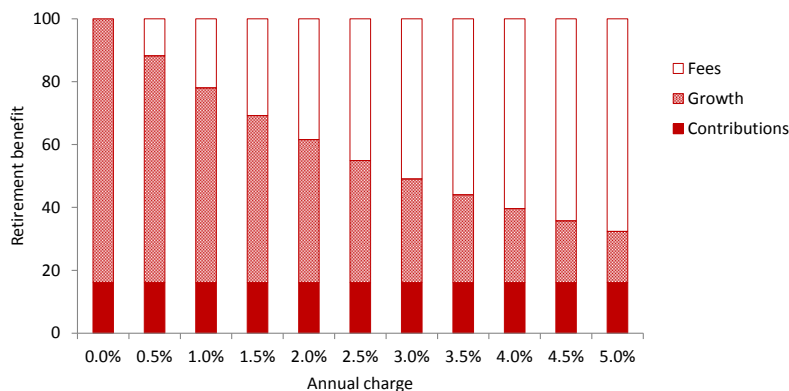
As can be seen, initial charges have very little effect on benefits. Even an initial charge of five per cent of each contribution only reduces final retirement benefits by five per cent.

The effect of recurring charges, however, is much more significant. Figure 4 shows the effect of recurring charges on the final benefit received by a regular saver over a period of 40 years. The same horizontal scale – from zero to five per cent – is maintained, although the charge is now levied on the entire balance each year. As may be expected, the effect of charges is much more significant.

For instance, if the recurring charges deducted from the fund account of a regular saver are reduced from 2.5 per cent to 0.5 per cent of assets each year, he or she would receive a benefit 60 per cent greater at retirement after 40 years, all else being equal.<sup>4</sup> Alternatively, the saver could get the same retirement benefit by making contributions over his or her lifetime that are around 40 per cent lower.

*Recurring charges reduce final benefits significantly*

**Figure 4: Effect of recurring charges on retirement fund accumulations after 40 years for a contributor**



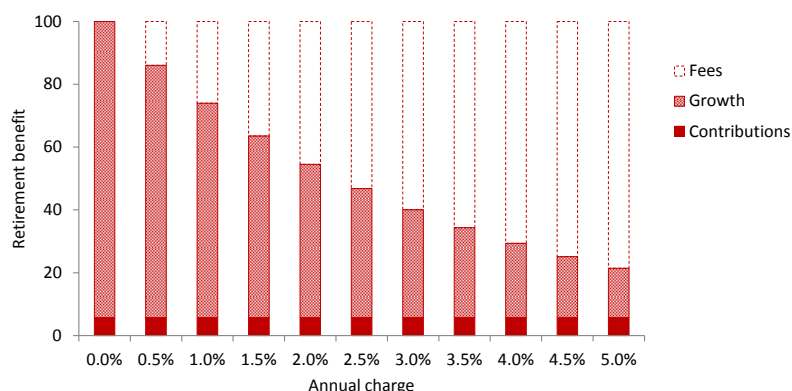
Source: Treasury modelling. Model assumes annual contributions increasing in line with wages over 40 years. Results are not sensitive to investment returns.

For members of preservation funds, the effect of recurring charges may be even more significant, depending on the term over which the individual is a member of the preservation fund. For instance, someone who is a member of a preservation fund for 30 years may see the reductions in final benefits shown in figure 5 for varying levels of annually recurring fees. Reducing charges from 2.5 per cent each year to 0.5 per cent each year increases the final benefits by around 80 per cent, all else being equal.

*Recurring charges are also highly significant for preservation funds*

<sup>4</sup> These results assume regular contributions increasing at 6 per cent per year for 40 years. Although investment returns were assumed to be 10 per cent each year, the results are relatively insensitive to the level of asset returns in the fund.

**Figure 5: Effect of recurring charges on retirement fund accumulations after 30 years for a preservation fund member**



Source: Treasury modelling. Model assumes annual contributions increasing in line with wages over 40 years. Results are not sensitive to investment returns.

The level of investment returns assumed do not have a significant effect on the results. Thus, while investment returns of 20 per cent each year may make an annual fee of 3 per cent of assets seem insignificant, the effect on the final retirement balance will be broadly equivalent to the figures shown here.

### The distinction between costs and charges

*Funds incur costs which are recovered from members through charges*

Retirement funds of all types need to perform various functions. These may include distributing the fund to members and prospective members, providing financial advice to members, administering the fund and the benefits, providing risk benefits, and managing and administering investments. To perform each of these functions, the fund incurs expenses, which, if they occur on a fund level, are called ‘costs’ for the purposes of this paper.

To cover these expenses, funds deduct monies from contributions or sell fund assets, reducing the value of members’ interest in the fund. These deductions, which occur at a member level, are called ‘charges’ for the purposes of this paper.

Most funds recover all of their costs by levying charges on members (although some employers may contribute towards the cost of running employer-related funds directly, or indirectly by performing services on behalf of the fund).

In practice, it is extremely uncommon for the charges to be recovered from members in a way which exactly matches the incurred costs of a fund.

### Examples of retirement fund costs

Typically, South African retirement funds perform several functions. Individual members must know about the fund, and must join it, and may receive financial advice before they do so. Funds must be administered, pay for risk benefits and manage investments. These functions are summarised for the different retirement funding channels in Box 1 on page 5.

Distribution costs borne by retirement funds may include fees for general consultancy services including communication, employee benefit consulting fees, and initial and trail commissions paid to consultants, if applicable.

Administration expenses may include the costs of death benefit distribution, risk cover broking and legal advisory services, fees payable to attorneys and counsel, accounting, audit and valuation fees, fees payable to principal officers and members of the boards of the funds, FSB levies and other charges, expenses in contribution collection, and banking fees, to name a few.

If funds invest via segregated portfolios, they incur investment-related costs that may include custody fees, investment consultancy fees, transition management fees, asset management fees including base and performance fees, stock-broking fees, exchange fees and securities transfer taxes, unitisation fees and investment administration fees including fees for portfolio monitoring and re-balancing, accounting and compliance reporting.

For funds which invest through multi-manager investment platforms, investment-related costs may include investment consultancy fees, platform fees for services provided by the platform including the investment administration services referred to above, and fees taken into account in the determination of 'unit prices' listed on the platform. These may include manager selection and unitisation charges, fees levied by managers of collective investment schemes (CIS's) or portfolios of assets backing the liabilities of insurers which issue linked policies through which platform-based investments are made, and the fees charged by the asset managers which manage those assets.

### **Determinants of retirement fund costs**

The main factors determining the cost of retirement funds include:

- *The size of the fund.* Significant fixed costs of running a fund and economies of scale in fund administration and investment management mean that funds with more members and greater assets under management typically have lower costs per member or per unit of assets than smaller funds.
- *The degree of preservation.* Systems with a greater degree of preservation accumulate more assets per member, all else being equal, and are therefore cheaper per unit of assets invested. The fact that rates of preservation in South Africa are low therefore imply that costs will be higher than they could otherwise be.
- *Whether the fund or system is mandatory or voluntary.* Generally employer, union, bargaining council and sectoral determination funds are mandatory once a fund has been set up. Retirement annuity funds and commercial umbrella funds need to be marketed and sold to prospective clients, who may be individuals or employers, adding to their cost, and with implications for their design.

*The main determinants of the costs of retirement funds*

- *Whether some fund functions are centralised or subsidised.* It is not uncommon for employers to subsidise some plan functions, and in some countries, but not in South Africa, a centralised clearing house performs many plan functions.
- *The level and cost of risk benefits.* Risk benefits are particularly important in South Africa. Funds with high numbers of lower-paid workers have much higher risk benefit costs than funds with higher-paid workers, reflecting higher probabilities of death and disability.
- *How assets are invested.* Plans which invest in fixed-interest instruments usually have much lower costs than those which invest in equities. Passive investment is usually cheaper than active investment. Investment in alternative asset classes such as property, private equity, and hedge funds may be more costly. Return guarantees are costly to provide.
- *The functions the system is required to perform.* This may include the extent of individual financial advice provided by the fund, the degree to which individuals or employers can customize the fund's investment strategies, or their risk benefits in relation to individuals or groups of members and the degree of discretion given to trustees in exercising their duties. Compliance with regulation is costly, but regulation also provides direct and indirect benefits to members.
- *Differences in the service quality.* Providing a higher quality of service, a greater level of financial soundness, and utilising a greater degree of skill in investment management is more costly.

## ■ What are charges and how are they measured?

In this section, the common charging methods by which retirement funds recoup their costs from members are described. Reasons why charging bases differ from the incurred costs of most retirement funds are then explored. Finally, different summary measures of retirement fund charges are presented.

### Different bases of levying charges

There are several different ways in which charges can be levied. Due to South Africa's decentralised, market-based system, there is no restriction on how charges are levied, and no requirement that all customers pay the same charges for the same services. In many cases, even in the retail market, fees are negotiable, and high-income individuals in particular may be able to negotiate substantial discounts on published fees.

*Percentage of salary / contributions.* One way that charges can be levied is as a percentage of member's (pensionable) salary or contributions to the fund. It is common, though not universal, for charges in the bulk market in respect of fund administration costs

*The various bases on which charges are levied, and the types of charge which typically use each basis*

and risk benefits to be levied on members as a proportion of salary or contributions.

*Percentage of assets under management.* Another common fee base is the aggregate value of assets under management. This is the basis on which charges are usually determined for investment-related services, including investment management, and administration.

*Percentage of returns.* In some systems, providers of investment products and services are permitted to charge a percentage of some measure of fund returns. These may be pure nominal returns or returns in excess of a benchmark, such as a measure of price inflation, or some index of asset returns. These types of fees are common in South Africa, but are usually performance fees intended to provide asset managers with increased financial incentives to outperform their benchmarks.

*Guarantee charges.* Some funds provide members with guarantees. These may be short-term guarantees, such as a guarantee that the value of assets held to provide for their benefits will never fall, or long-term guarantees, such as a guarantee that the maturity value of a policy will never be less than the contributions made. Guarantees may be provided by the capital of an insurance company, or through the use of financial derivatives. In some systems, guarantees are mandatory.

*Fixed costs per member per year.* Some funds levy a fixed charge per member per year. Although these are a feature of some RAF's, they are relatively rare in group funds, possibly because high charges might cause low-income employees to stay out of the occupational retirement funding system altogether. Umbrella funds often quote administration costs using this basis, although charges for these are typically levied on members as a proportion of payroll or contributions. Some umbrella funds also levy a fixed charge per employer for some administration-related costs.

*Fixed conditional charges.* These are charges associated with specific member-related events, including when members fail to make agreed contributions, alter their contribution schedule, terminate their membership of the plan, switch their investments from one portfolio to another, or access financial advice.

Some conditional charges may be expressed as 'refunds' of fees – for instance, some RAF's levy early surrender penalties on members by over-charging all members for plan administration and 'refunding' a portion of these fees to members who remain in the fund for long periods.

### **Measuring and comparing charges**

Given the complexity of the many charging bases, it is necessary to develop a simple and comprehensive measure of their effect on consumers in order to compare them. Four measures are currently in wide use. Two measures focus on charges over the whole lifetime of a product – the Reduction in Yield (*RiY*) and the Reduction in

*Consolidated measures of charges assess the effect of charges on members*

Maturity Value (*RiMV*). The *RiY* measures the extent to which charges reduce the returns earned on an investment product each year, while the *RiMV* measures the extent to which charges reduce the final maturity value of the product. Both are relative to a hypothetical account in which the asset returns of the underlying investments are the same, but where charges are set to zero. Both are also forward-looking, and depend on a range of assumptions, which may or may not be realised in practice.

Two other measures focus on annual charges in retirement funds. The first takes the total charges paid by a fund or member in any one year, and divides it by the assets under management in a fund. This is called the Accounting Cost per fund Assets (*ACA*) measure, and is broadly similar to the Total Expense Ratio (*TER*) reported by many retail CIS's (although the *TER* may exclude some indirect costs). Alternatively, the total costs incurred by a fund can be divided by the number of members in the fund, in which case it is called the Accounting Cost per Member (*ACM*) measure of charges.

All of the measures described here struggle to deal with conditional charges, such as guarantee charges, performance fees or early surrender penalties. Excessive reliance on any particular measure may therefore give providers an incentive to shift charges in order to exclude them from the particular measure chosen.

Measures of charges are described in greater detail in Appendix A.

### **Factors influencing a charging basis**

*Factors which influence the actual charging basis used by funds*

In a competitive market, the charge for each individual service should match the economic cost incurred in performing that service. Economic costs include provisions for normal profits for product and service providers, where appropriate.

In practice, though, it is highly unusual for the charging basis to match the incurred cost basis exactly. There are several reasons for this, some of which are listed below.

#### *Governance*

Non-commercial funds aim simply to recover their costs by charging members or participating employers. Typically, these funds do not need to attract members, since membership is usually compulsory, and therefore they have little incentive for charges to differ significantly from their costs.

Commercial funds, on the other hand, need to be sold to customers. Although they may invest their own resources in distribution and marketing, the sponsors of these funds aim to recoup their distribution costs from fund members. Further, sponsors may have an incentive to make their charges appear palatable to customers and intermediaries. This could result in an increase in the complexity of funds, and the different types and layers of charges.

Also, different governance arrangements may result in different types and levels of conflicts of interest. While all funds subject to regulation in terms of the PFA are required to have boards to direct,



control and oversee their operations, only some are currently required to give members the right to elect some of the members of those boards. Boards of commercial umbrella funds are often appointed, directly or indirectly, by service and product providers. Non-commercial funds may be used to further the mission of the sponsoring organisation in ways which could adversely affect the interests of current members.

### *Regulation*

In many countries, there are regulations which determine the type and level of charges which may be levied on members of retirement funds. For instance, many countries with mandatory DC retirement systems limit the permitted types of charges, and require that all members are levied charges on the same basis. Some jurisdictions restrict the maximum level of charges. International regulation of fees, and efforts to reduce them, are discussed in Appendix B.

In South Africa, besides maximum commission scales paid to intermediaries in group and individual life insurance policies, which may include underwritten umbrella funds, there are no restrictions on charges in retirement funds. Reliance is placed exclusively on the market mechanism to regulate both the type and the level of charges. With some qualifications, this is similar to other Anglo-Saxon markets, such as Australia, Ireland, the US and the UK, although all of those countries have attempted or are currently attempting to reduce charges in their retirement system in various ways.

### *Redistribution*

Many of the costs incurred by retirement funds do not depend on either the size of the contributions made or the assets under management, but are rather fixed per member. A charging structure which fully reflected costs would therefore heavily penalise members with small balances and low salaries. Most funds therefore choose charging structures which are redistributive.<sup>5</sup>

### *Nature of customers*

Members of compulsory membership funds usually have no choice but to remain members of those funds and, particularly if they are members of umbrella funds, little control over their costs. They are reliant on their employers, unions, boards of management and management committees (in the case of umbrella funds) or prior boards of management, to choose retirement products or service providers on their behalf. While this has definite advantages, given the difficulty that most people have in making appropriate financial decisions, some of these decision-makers may have little interest in ensuring that employees are getting value-for-money, particularly with regard to recurring charges.

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<sup>5</sup> *The extent to which voluntary charging structures can achieve redistribution is limited, since, in a voluntary system, individuals may opt out of the system in various ways if the extent of redistribution is too large.*

Further, the sensitivity of customers to charges in retirement funds seems low, especially if they are recurring charges based on the value of the fund's assets. This is because the impact of retirement charges is not felt directly and, to a member, the rate of these charges expressed as a percentage of value of assets may seem low. Instead, high charges only reduce an individual's consumption when retirement benefits are paid, which may be in many years' time. Most individuals are unable to assess, in advance, the impact over many years of apparently small recurring charges, and few value the future sufficiently highly to take action to reduce them in the present.

### *Intermediation*

While intermediation serves important functions, it can increase the complexity of products and charging structures. This is partly because intermediation is costly and needs to be paid for by levying charges on members, and partly because intermediaries probably lessen the negative impact that complex charging structures have on potential customers.

### *Competition*

The more competition in a market, the more likely charges are to match costs. Necessary, but not sufficient conditions, for competitive markets include transparency of charges and product terms, comparability and portability of products between providers, financially informed and active consumers and low barriers to entry and exit by providers.

### *Disclosure*

Section 7D of the PFA requires the board of a fund only to 'ensure that adequate and appropriate information is communicated to the members of the fund informing them of their rights, benefits and duties in terms of the rules of the fund.' The Registrar of Pension Funds has issued non-binding guidance circular PF 130 in which he said at paragraph 65:

'The fund's investment performance, the average costs per member and also, in respect of any fund which has independent board members, the fees and disbursements paid to or in respect of them, must be communicated to members at least once a year. Members should also be aware of who the service providers of the fund are.'

He has also advised in that circular and in circulars PF 86 and PF 90 that he expects other disclosures to be made to members in their benefit statements and by allowing members of these funds to access the financial statements of the fund and the Trustees' Report, if any. PF86 and PF90 make no direct reference to charges, however.

A charging basis which exactly matched the costs incurred by a fund would be very difficult to communicate to members and difficult to administer. Furthermore, to the extent that disclosure requirements between different types of charges and products vary, providers may have an incentive to shift charges toward less obvious or transparent methods of generating revenue.

### *Pricing power*

If they have pricing power, providers may be able to raise charges substantially above the long-run equilibrium level, and earn extra profits as a result. If customers are uninformed, exhibit substantial inertia, are unresponsive to the level of fees, and there are substantial barriers to entry into the industry, pricing power may be substantial.

Pricing power may differ between different charges if members – and, more importantly, prospective members – are more sensitive to some charges than to others. For instance, a high level of initial charges may deter members from joining funds, while the same amount could be recovered over a longer term by increasing annual fees with little effect on member behaviour. This may give service providers an incentive to increase less visible charges and use the excess revenue to subsidise a reduction in the more visible charges.

### *Price discrimination*

The lack of charge regulation and the wide variety of product variations permit providers to engage in price discrimination of various types. Possibilities may include early surrender penalties or loyalty bonuses, headlining uncompetitive prices, offering varying levels of ‘discounts’ to different customers or intermediaries, or using product differentiation (e.g. the extent of investment choice, different levels and types of risk benefits) to encourage customers to self-select into differentially-priced products.

In principle, economic theory suggests that price discrimination is only welfare improving if it increases the total amount of product produced in a market.<sup>6</sup> However, even if it does increase the total amount of output, it may still harm society if its dead-weight cost (added search costs, added administrative complexity and consumer errors, amongst others) exceeds the benefits to consumers. Anglo-Saxon countries aside, most countries have banned all forms of price discrimination in their retirement systems, although there may be a case for volume discounts (often called second-order price discrimination).

## ■ Next steps

In the rest of this document, the costs in each type of retirement fund are discussed in detail. Each chapter will first examine the determinants of the costs and charges of funds in that channel. Then, some brief empirical evidence on the actual level of charges of funds in that channel will be examined, where available, followed by an international comparison, where possible.

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<sup>6</sup> For a technical summary of the theory, see ‘Price Discrimination and Competition’, by Lars Stole, in Mark Armstrong & Robert Porter (eds.), 2007. “Handbook of Industrial Organization”, Elsevier, edition 1, volume 3.

### 3. Non-commercial funds

Standalone occupational retirement funds, bargaining council funds, union funds and sectoral determination funds typically operate on a non-commercial basis. In terms of the PFA, unless they have been exempted from this requirement, members of these funds must be given the right to elect at least 50% of their boards of management. Legally, once elected, board members must serve the fund and its members as a whole, rather than ‘represent’ the interests of the constituency which appointed them.<sup>7</sup>

Although larger funds may perform some functions in-house, most funds in this category have no administrative or fund management capabilities. Taking appropriate advice from experts, boards of management procure risk cover and accounting, legal, actuarial, administration and investment-related services from specialist third parties, under what might loosely be called a ‘pure procurement’ model. This means that quotes for different services might be obtained from various providers, and that the board will choose particular service providers taking into account a range of factors, of which cost is just one.

A fund might be ‘underwritten’, meaning that the board purchases a policy from an insurance company in terms of which, in return for the payment of premiums, it undertakes to pay the benefits provided for in the fund’s rules and to provide most, if not all, of the fund’s required services.. In such a case, the fund will not operate its own bank account, and the only asset of the fund will be the policy. The insurer will hold assets and liabilities on its own balance sheet in respect of this policy, as well as any required regulatory capital.<sup>8</sup>

It is important to note that while these funds are operated on a non-commercial basis, in some cases the financial interests of employers, trade unions and other interested parties may have an inappropriate influence on the decisions of boards in relation to the purchase of financial products and services.<sup>9</sup> The fund may therefore be only one element in a complex relationship between employers, employees and other organisations.

#### ■ Drivers of fund costs and charges

*Factors keeping costs of non-commercial funds low*

Non-commercial retirement funds do not need to be marketed to prospective members, since membership of them is compulsory. They also do not typically provide financial advice to members, may receive subsidies from their associated employers, and are relatively

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<sup>7</sup> See the judgment of the Witwatersrand Local Division of the High Court in *PPWAWU National Provident Fund v Chemical, Energy, Paper, Printing, Wood And Allied Workers’ Union (CEPPWAWU)* 2008 (2) SA 351 (W).

<sup>8</sup> It is increasingly common for these funds to be folded into umbrella funds.

<sup>9</sup> Some influence may be appropriate e.g. if the unions or employers try to influence the board members appointed by them to select value-for-money products and services in the interests of their members / employees.

mature in terms of membership and assets under management. Further, most procure risk benefits in the group market, which is quite competitive and highly cost-effective. These all serve to lower their costs.

As discussed, most funds procure services from service providers, and must recover their costs from members or the employer through charges. A key factor underlying the level of these charges is therefore how successfully the boards of management of these funds are able to obtain good value from service providers.

## **Governance**

A well-run board of management has the power – and should have sufficient expertise and experience, or be able to hire such expertise – to select, appoint on appropriate terms and supervise providers of products and services to the fund in a way which ensures that the best interests of the fund and its members are served. Since the amounts at stake are large, there are significant incentives to invest time, money and effort in making careful decisions and exercising close oversight.

*Good fund governance is crucial in keeping costs low*

However, in practice, their behaviour in this regard is constrained by several factors. Many board members perform their services on a voluntary basis and in addition to their normal workloads. They may be unprepared to engage effectively in negotiations with providers of products and services and to exercise oversight over the work of those providers after appointing them. Some may also allow themselves in some instances to be made subject to inappropriate influence in the selection of providers, whether by those providers through personal friendship networks, in the form of illegal inducements or otherwise, or by their employers, trade unions or other persons of influence (such as a domineering chairperson of the fund's board).

Further, as the boards of funds are not explicitly required by law to disclose to members of the funds the charges levied by product and service providers, or even the fees paid to those boards members who earn 'trustee fees', there is no basis on which members of the funds can try to hold the boards to account on these matters.<sup>10</sup>

## **Administration**

Pension administrators may, in practice, have significant market power. The costs associated with acquiring and maintaining the information technology infrastructure, human capital and distribution networks required to run an effective retirement fund administrator, and particularly one servicing funds with large numbers of members, provide a substantial barrier to entry. These factors, together with the costs and disruption associated with

*Administrators may have substantial market power*

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<sup>10</sup> *Circulars PF86, PF90 and PF 130, in which the registrar has sought to provide guidance to retirement fund boards on, amongst other things, disclosures to be made to members, are currently being reviewed by the FSB as part of the Treating Customers Fairly initiative with a view to replacing them by enforceable directives.*

changes to providers of administration services and inertia on the part of boards of retirement funds, have been factors enhancing the pricing powers of fund administrators.

While it is often asserted that fund administration is not itself a profitable business, administrators may utilise their market power to promote the purchase of products and other services from the administrator or organisations in which it has a financial interest. These products and services may include risk benefits, consulting, broking, valuation, legal, accounting and communication services and investment-related products and services.

The purchase of these services may be promoted by bundling them with administration services for which charges are set at relatively low rates. This type of arrangement may be used to shift charges away from initial charges, and towards less-visible and more lucrative recurring charges.

### **Investment consultancy services**

*Consultants may introduce conflicts which raise the costs of investment management*

Boards of management are required by the PFA to take advice from investment consultants if they do not have sufficient expertise on their own. Consultants increase the efficiency of the asset allocation decision by guiding trustees through the asset allocation decision and the investment management process. However, in common with other types of financial intermediation, reliance on consultants may also have negative effects, particularly if they are employed by parties related to other providers of investment-related products or services. Effective boards will be aware of these and will have the skills to manage their relationships with consultants appropriately.

In general, investment consultants, like other intermediaries, have a bias towards products and services which increase their overall fee income. One example may be favouring active mandates over passive ones, as, if consultants can persuade boards of management that it would be appropriate to select managers to manage different portfolios of assets on the basis of an assessment by the consultants of their skills relative to those of their competitors, this gives scope for higher consulting fees. Other examples may be investment mandates which incorporate performance fees, or complex, highly structured investment products.

To the extent that investment consultants may fail to render effective intermediation services in relation to the appointment of asset managers, this could contribute to the pricing power of those managers. Consultants may also be conflicted between their duties to their clients and their own interests in their relationships with investment managers, having an inappropriate influence on their judgment. This risk may be exacerbated by concentration in the market, particularly amongst consultants capable of providing the range and depth of services required by large funds.

While disclosure of potential conflicts between interests and duties is required in terms of FAIS, it may be difficult sometimes for boards to assess the true nature, extent, and risks associated with even those conflicts which have been disclosed.

## Investment management and administration services

Investment management and administration services may be provided directly to retirement funds, if their assets are managed and their investments are administered on a segregated basis. Alternatively these services may be provided to them indirectly through ‘pooled’ products such as linked policies and CIS’s (including, for the purposes of this paper, hedge funds and private equity funds) in which retirement funds may invest. The basis on which fees are payable to the providers of various services to the issuer of the pooled products, including asset management, unitisation and the like, are determined by agreement between them and those issuers, which means that the influence that the ultimate consumers of those products – retirement fund members and the boards of management of the funds they are members of – have over the charges levied for them is low. Furthermore, the issuers may be able to derive substantial other advantages from the assets backing those products in the form of, for example, scrip-lending fees, ‘bulked’ interest at preferential rates and fees and other benefits derived from the provision of ‘platform’ services discussed below.

## Investment platforms

Investment platforms are discussed in more detail in Appendix C. They are commonly used by smaller stand-alone funds. They give these funds access to economies of scale, with standardised investment mandates, and allow them to implement complex investment strategies, or switch investment strategies, much more easily than might be the case with stand-alone mandates.

*Investment platforms may introduce conflicts between investment managers and retirement funds and their members*

However, investment platforms act as distributors of fund management services by retirement funds, and as such, they are conflicted between buyer and seller. Implicitly or explicitly, they derive their revenue from two sources – fees levied on retirement funds that use their platform, and commissions – otherwise known as rebates – from investment managers which they choose to list. Broadly speaking, the balance of revenue between these two sources determines the extent to which the platform has an incentive to lower – or to raise – aggregate investment management costs. For this reason, the Financial Advisory and Intermediary Services Act of 2002 (FAIS) requires providers of investment platforms to disclose the rebates they receive from investment managers to their customers. However, the effectiveness of this code is unclear in practice, and boards of retirement funds may not be aware of the broader implications of such disclosures.

Investment platforms also create layered charging structures which may obscure the relationship between the fees that are charged and the services performed in respect of them, particularly if rebates are paid between different layers of the structure.

## ■ Charges in non-commercial retirement funds

*Large standalone retirement funds may cost members between 0.7 per cent and 1.5 per cent of assets each year*

Three recent studies have examined charges in stand-alone retirement funds. However, since employers often provide ancillary services to retirement funds, cost comparisons with other non-commercial funds may be difficult. Further, there is a wide dispersion of fund size, so any average conceals a great deal of heterogeneity.

Davies (2010)<sup>11</sup> used a large FSB dataset to analyse charges in South African retirement funds of this type. He found that these funds had an average ACA of 0.99% p.a. when only DC funds are considered (making the assumption that DB and DC funds had equal levels of charges). However, since investment management charges may often be netted off asset returns, this may be an underestimate.

Gluckman and Esterhuyzen (2011)<sup>12</sup> analysed cost data from four reasonably large standalone retirement funds, and calculated *RiY* and *RiMV* statistics using a standardised methodology of their own design. They found an average *RiY* of around 1.03%, and an average *RiMV* of 12.75%, with the average number of years to retirement of participants being 22 years.

Rusconi (2004)<sup>13</sup> also examined charges in standalone retirement funds. His data set was less complete than Davies (2010) or Gluckman and Esterhuyzen (2011), and he came up with higher total costs, equivalent to an annual ACA of between 1.04% and 1.65% p.a.

## ■ International comparison

*International measures of average plan costs are significantly lower than large SA plans in most cases*

Non-commercial group arrangements are prominent in Australia, the Netherlands, the US, the UK, and Japan, among other countries. Mostly, these are sponsored by employers, although in the Netherlands, and some other European countries, industry-wide funds are common as well.

Large South African plans perform near the bottom of this sample, with only ‘average’ plans in the USA and Japan being more expensive.

Since these plans operate on a ‘pure procurement’ model, and are mandatory, another source of comparison is other plans which operate on this same model. Table 3 gives examples.

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<sup>11</sup> Anton Davies, 2010, *Pension Scheme Administration – A South African Context, results from a 2009 study*, Compass, <http://www.asisa.org.za/index.php/events/retirement-reform-seminar.html>.

<sup>12</sup> David Gluckman and Megan Esterhuyzen, 2011, *A critique of the Umbrella Retirement Fund Charging Model*, Actuarial Society of South Africa, Annual Convention, 2011.

<sup>13</sup> Rob Rusconi, 2004, *Costs of Saving for Retirement*, Actuarial Society of South Africa, Annual Convention, 2004.



**Table 2: International comparisons of costs of large non-commercial pension funds, DC unless otherwise stated, ACA measure, % of AUM p.a.**

Country	Investment		Total
	Admin fees	management fees	
USA	0.01%	1.01%	1.02%
Japan	0.32%	0.20% – 1.50%	0.52% – 1.82%
UK (DB & DC)^	0.40%	0.20% – 0.50%	0.60% – 0.90%
Netherlands (DB & DC)	0.19%	0.20%	0.39%
Australia	0.24%	0.47%	0.71%

^ DWP Research Report No 804 (DWP, 2012) reports a median charge for employer-based DC funds of 0.71% of assets under management each year. Contribution-based charges were rare in their sample.

Source: Investment and Financial Services Association, 2009, *International superannuation and pension fund fees*.

**Table 3: International comparisons of ‘pure procurement’ plans.**

Plan / system	ACA (various sources)	Notes
Bolivia	0.5%	Mandatory public system, centralised clearing house
Sweden	0.4%	Mandatory public system, centralised clearing house
NEST (UK)	0.4%^	Automatic opt-in public system
Thrift Savings Plan (US)	0.03%	Occupational plan for US Federal Government employees, subsidies from forfeited contributions

^ This is a Reduction in Yield measure. Current ACA likely to be higher as plan is still very immature.

Source: Bolivia and Sweden from Tapia, W. and J. Yermo, 2008, “Fees in individual account pension systems: a cross-country comparison”, OECD Working Papers on Insurance and Private Pensions, No 27, NEST (UK) from [www.nestpensions.org.uk](http://www.nestpensions.org.uk), assumes steady state ACA based on current charges, Thrift Savings Plan from [www.tsp.gov](http://www.tsp.gov).

Factors limiting the comparison are:

- The figures quoted in Table 2 are averages; in many cases, cheaper plans are possible.
- The US figure shows average 401(k) plans, many of which are run by commercial providers. There has been concern about the level of expenses in these plans for many years, and disclosure requirements have recently been significantly increased in an attempt to reduce the average level of charges.
- Figures may be subject to bias – for instance, in the Netherlands, many plans report zero asset-management fees, suggesting that asset returns are often quoted net of charges, making these plans appear cheaper than they actually are.
- Plans in the UK and the Netherlands tend to invest more heavily in bonds than South African plans. Bond portfolios are often cheaper to manage than equities.
- There is a heavier use of passive investment management in international markets than in South Africa. As discussed in the appendix, over the long term, in efficient markets passive management is not demonstrably inferior to active management, and it is significantly cheaper.
- Average contributions and assets under management are higher in many countries than in South Africa.

*Factors which limit the degree of comparability across countries*

## ■ Draft policy options

Large and well-run non-commercial retirement funds appear to offer South Africans the cheapest way to save for their retirement. There is, however, still room for improvement relative to international benchmarks. The following policy options may be considered:

*Explicit principles-based statutory requirements for trustees*

- The duties of trustees in regard to the fund and the members, as well as a duty to ensure that funds fulfil their objectives cost-effectively, may be made explicit in statute. One further option may be to require all funds to have independent and/or expert trustees in line with King governance principles.

*Strengthened disclosure requirements*

- Strengthening the reporting requirements on funds by requiring all charges paid or otherwise borne by funds, or by members, employers and/or intermediaries in relation to funds, be reported on a look-through basis to the regulator. This should include administration costs, the explicit costs of intermediation, if any, including commission, consulting fees, and direct and indirect costs of investment management, including stock broking fees, guarantee charges and Securities Transfer Taxes, if applicable.

*Limited investment choice and restrictions on charges in the default option*

- Strengthening disclosure requirements to members by developing a standardised summary metric of charges which is required to be disclosed to members in a form which is comparable to charges on other investment channels. Possibilities might be based on a *TER* or a *RiY*, but should include some allowance for conditional charges. The Registrar could collate these summary measures and require funds to provide their members with their ranking or relative level each year.

- Investment choice in stand-alone funds may be limited to a certain maximum number of options, all of which comply with prescribed criteria. Funds may be required to have a default investment option, which should also meet certain conditions, including a very simple charging model and possibly a cap on the annual charge on assets under management. This will restrict the ability of service providers to shift charges onto less-visible recurring charges without limiting their ability to determine an appropriate overall charge level. Complex charging structures including performance fees, termination penalties, and market value adjustments will be examined closely.

*Regulating intermediary commissions, including investment platforms*

- Charges levied by employee benefit consultants could be made subject to regulation designed to fully align the incentives of intermediaries with their customers, rather than with service providers, if this is indicated by a more detailed review of incentives now used to distribute products and services to retirement funds. Investment managers could also be required to use 'clean' unit pricing and forbidden from paying rebates to distributors.

- In order to increase the competitiveness of the market for investment-related products and services, model or template agreements between boards of management and providers of investment-related products and services could be developed. Consideration will also be given to making public the prices at which equivalent products and services are offered by providers in some form. The role of performance fees, discussed in an appendix, will be examined closely.
- A set of standard templates could also be developed by the FSB to assist funds in understanding and applying best practice. Examples may include sample retirement fund and policy documents such as pension increase policies, member investment choice policies, governance and model agreements between funds and service providers.

*Developing standardised investment mandates*

*Developing a set of standard fund templates*

## 4. Commercial umbrella funds

Commercial umbrella funds are group arrangements run on a for-profit basis by a sponsor, which may be an asset manager, an insurance company or a specialist retirement fund administrator or consultant.

*Commercial umbrella fund governance may be conflicted*

Like not-for-profit funds, they are set up as stand-alone funds, overseen by boards of management. On application, however, umbrella funds may be exempted from the requirement that members elect at least 50% of the board, provided that there is at least one independent board member with no commercial or other ties to the fund sponsor. Other than the independent or elected board members, most are typically appointed directly or indirectly by fund sponsors. This raises the possibility of conflicts of interest between boards and members.

*A broad range of funds in practice*

In practice, commercial umbrella funds function in a broad variety of ways. Although the fund sponsor typically performs the administration, besides this, some umbrella funds function very like the ‘pure procurement’ funds described in the previous section, while others are little more than legal vehicles for administering the products sold by the commercial sponsor.

*In many cases, fund rules limit the discretion of trustees*

For instance, the rules of some commercial umbrella funds limit the investment options available to members to investment products presented to the fund by the sponsor, and require the funds to purchase from the sponsor or related insurers policies in terms of which some or all of the fund’s liabilities are underwritten. Others may permit a broad range of insurance and investment product providers, but require consulting and other services to be procured from the sponsor. To the extent that boards of management are unwilling or unable to switch service and product providers, commercial umbrella funds cannot operate as ‘pure procurement’ funds in the same sense as non-commercial funds. This is despite the fact that the PFA – besides the requirement for independent board members – recognises little difference in the protections granted to members of commercial umbrella funds and non-commercial funds.<sup>14</sup>

*Competition between service providers at customer level is crucial*

To function effectively, the market for commercial umbrella funds therefore relies to a large extent on competition between service providers at customer level. Requirements for competitive markets include, but are not limited to: transparency of charges and product terms, comparability and portability of products between providers, financially informed and active consumers and low barriers to entry and exit by fund sponsors.

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<sup>14</sup> This is particularly significant, since in terms of the ITA, members are required to join umbrella funds as a condition of employment once their employer has elected to join such a fund.

The market also relies on employers, the effective purchaser of the retirement fund ‘product’ in relation to which its employees will be the ‘consumers’, to select funds that represent best value for money. Many employers may not have the expertise, experience or access to information required for the purpose, and there is no reporting standard for charges to assist them. As a result, some may be persuaded by low up-front charges to sign their employees up for membership of a commercial umbrella fund without realising the impact that the less visible recurring charges will have on their retirement benefits.

*Employers must also choose umbrella funds in the best long-term interests of their employees*

## ■ Drivers of fund costs and charges

The functions performed by commercial umbrella funds are broadly similar to those performed by non-commercial funds. One important difference, though, between commercial umbrella funds and non-commercial funds is that commercial umbrella funds need to be marketed and sold to customers, usually through intermediaries, who require compensation. The sponsor may recover these charges directly from participating employers, or indirectly via charges on members.

*Commercial umbrella funds must be sold to customers*

Commercial umbrella funds may be slightly more costly to run than non-commercial funds. Each commercial umbrella fund usually consists of a number of sub-funds, each of which is operated for employees employed by a single employer or a group of related employers such as a holding company and its subsidiaries. ‘Special rules’ applicable to each sub-fund may specify rates of contribution and the right to risk benefits which may be different to those applicable to another sub-fund. Investment is often done through unitised CIS’s or insurance policies (linked policies and/or guaranteed policies) listed on investment platforms, rather than directly in underlying assets. Benefit payments may also be complicated by a lack of integration of the fund with each participating employer’s human resources department.

*Umbrella funds are more administratively complex than stand-alone and non-commercial umbrella funds*

Commercial umbrella funds may also provide different levels and quality of service. Some may provide on-going interaction and reporting to members; others may rely on brokers to do that, and some may have little on-going interaction besides at an administrative level. The more services provided to members, the higher the cost.

Although the commercial umbrella fund market is still a relatively small proportion of the total retirement fund universe, the nine largest funds together have assets of around R90bn and more than 1 million members. In principle, the few largest commercial umbrella funds should have reached full economies of scale for administration and investment management.

*Largest umbrella funds should have reached full economies of scale*

*Reasons why market for commercial umbrella funds is unlikely to be fully competitive*

### **Competition between different umbrella funds**

Although there is competition between different commercial umbrella funds, in some respects the market for umbrella funds may not meet the standard requirements for a competitive market.

First, it can be very difficult for customers to compare the different products offered. Providers have little incentive to keep charging structures simple and easily understandable, at least partly because commercial umbrella funds are sold through intermediaries. There appears to be a profusion of different charges and charging structures, with varying levels of disclosure between funds. Unlike in the retail market, there is no standardised disclosure requirement to allow customers to compare the costs of different products on the same basis. This lack of comparability is exacerbated by the large degree of flexibility in umbrella fund design and in the services provided to members and employers.

Secondly, investment-related products and services provide a further source of product differentiation. To the extent that customers can be persuaded that different managers or investment structures are not close substitutes, commercial umbrella funds may be able to offer a large variety of different investment options, reducing economies of scale, and raising charges.

Thirdly, barriers to entry in the commercial umbrella fund market may be substantial, partly due to the high cost of the technology and human resources required for effective fund administration, the fundamental importance of trust in a long-term contract such as retirement saving, partly due to economies of scale which favour providers which are already large, and partly due to the importance of distribution networks, which are costly to build. High barriers to entry reduce competition.

Finally, in practice, it may be difficult for employers and their employees to switch between different commercial umbrella funds. Transfers between funds are governed by section 14 of the PFA. For various reasons, which may include uncooperative behaviour by representatives of the transferor fund or its sponsor, section 14 transfers may take a substantial amount of time to finalise, in some cases up to a year or longer. Considering the inherent conservatism of most employers in pay-related issues, employers may therefore only commence the transfer process with some degree of reluctance. This further reduces competition.

### **Efficiency of procurement by employers**

Although direct umbrella fund customers (employers or boards of management) do have some incentive to ensure that costs are low, and are likely to have a higher level of skill than individual members, employers may not always act in the best interests of their employees.

In particular, employers may be easily persuaded by low up-front charges (that is, those deductible from contributions) to select a commercial umbrella funds that in fact, because of higher recurring charges, represents lower ‘value-for-money’ than other commercial umbrella funds.

*Employers may be persuaded to accept umbrella funds with lower initial charges*

### **Charge shifting and price discrimination**

For these reasons, the providers of commercial umbrella funds may find it easier to sell membership of their funds if they reduce highly visible initial charges on contributions, and raise annually recurring charges expressed as a proportion of fund assets.

*Providers may have an incentive to shift charges onto recurring charges*

For instance in commercial umbrella funds, administration and consulting charges are sometimes expressed as a percentage of assets under management (in non-commercial funds, these are more often expressed either as a proportion of contributions, a per-member per month or on a fee-for-service basis). Many providers who manage commercial umbrella fund assets in-house may also undercharge for administration, even to the extent of losing money, but make higher profits on asset management. Charge-shifting of this type may also have significant adverse consequences – if providers believe that administration is a loss-making activity, they may under-invest in it, leading to sub-optimal outcomes.

Another form of charge-shifting may apply to employers with small numbers of employees or significant numbers of low-paid employees. A large fraction of these members appear to be invested – in some cases by default in commercial umbrella funds – in smoothed bonus products which provide guarantees, against which charges are levied. The higher fees – some called ‘guarantee charges’ – earned by providers from these products compensate them for the higher administration and distribution costs in this business segment. These products are discussed in detail in an appendix.

The value-for-money of guarantee charges is extremely difficult to assess, in general, yet guarantees are highly valued by individual members and retirement fund boards.<sup>15</sup> Providers may therefore also have an incentive to lower administration and asset management charges and raise guarantee charges if investors invest in guaranteed portfolios.

Price discrimination of various kinds may also be used. This may be achieved either through changes in product design (level of investment choice, presence of guarantees, surrender penalties) which encourage self-selection by customers into differentially-priced products or uncompetitive headline prices, against which ‘discounts’ are offered through preferred distribution channels.

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<sup>15</sup> However, in smoothed bonus policies, the difficulties are compounded by the complexity of the various policy designs, and the fact that the cost of the guarantees provided are, in practice, shared between policyholders and shareholders rather than borne entirely by shareholders. Shareholder support to these portfolios has been extremely limited.

Finally, sponsors of commercial umbrella funds may profit from cross-selling various services, such as living or conventional annuities, home loans, insurance products or investment services to fund members.

*Formal disclosure requirements are low, although these may be exceeded in practice*

### **Disclosure**

Commercial umbrella funds face two sets of disclosure requirements. The first is regulated by FAIS, and applies only when they are first sold to employers. Employee benefit consultants are subject to the codes of conduct relevant to their category of financial service provider under FAIS. This includes a full disclosure of the charges of the financial product being sold. However, it is unclear how effective this requirement is in practice.

At present there is no regulation governing the disclosure of costs and charges after entry into a commercial umbrella fund. Although members of funds are entitled to see the fund's rules and financial statements, few probably do so, and not all charges may be reflected in these documents, especially if funds invest through CIS's, hedge funds, private equity funds or insurance policies rather than directly. Most commercial umbrella funds probably exceed these requirements, since it is unlikely that employers would elect to remain participants in a fund whose disclosure levels were inadequate. However, the opportunities for imperfect disclosure of charges to members may be substantial.

### **Intermediaries**

*Intermediaries may be conflicted*

As in other markets, intermediaries may suffer from conflicts of interest caused by the fact that they are advising customers, but are often remunerated by product providers. Employee benefit consultants must be registered as Category I, and, if they also provide intermediary services, Category II, financial service providers under FAIS, and are therefore subject to the relevant codes of conduct. These require full disclosure of fees. However, there is concern, as in other markets, about the extent to which customers receive value-for-money in respect of the trail commissions they pay.<sup>16</sup> Many intermediaries may receive trail commissions from product providers and then subsequently act as financial advisors for individuals who leave the fund, receiving further commission.

Commercial umbrella funds may also use investment platforms, described in detail in an appendix.

## **■ Charges in commercial umbrella funds**

Gluckman and Esterhuyzen (2011) examined charges of commercial umbrella funds in some detail, although their sample was restricted to one particular provider.

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<sup>16</sup> *Maximum commission scales are set for group life business. However, these scales may not be applicable to non-underwritten umbrella funds, and may easily be exceeded in practice for this and other reasons.*



They calculated *RiY* and *RiMV* for each individual member of each sub-fund using a standardised methodology. The average *RiY* was 1.90%, and the average charge ratio was 18.68%, substantially higher than the results for non-commercial funds. Once guarantee charges were allowed for, the *RiY* increased to 3.14% p.a. (more on which below). Using the same methodology, average *RiY* in this fund fell to 1.70% in 2012 and 1.65% in 2013, again excluding guarantee charges.

*Average reductions in yield in commercial umbrella funds*

Their 2011 results were very similar to those of Davies (2011) for umbrella funds, who found an *ACA* of around 2% p.a.

There are two limitations of the Gluckman and Esterhuyzen (2011) study which may serve to bias their estimates of cost downwards. Low-income workers in one of the provider’s options were excluded and the reason for their exclusion was unclear. In their study, low-income workers often have the highest *RiY* and *RiMV*’s. Further, they explicitly ignored guarantee premiums on the grounds that the premiums are purchasing insurance rather than a cost. However, guarantees are hard to value and much of what is called a guarantee charge may actually be a portfolio management charge, particularly for smoothed bonus products. Guarantees on these are discussed at length in a technical appendix.

*Studies exclude guarantee charges*

**Box 4: Are economies of scale being passed on to participants in commercial umbrella funds?**

	<b>Non-commercial umbrella fund</b>	<b>Commercial umbrella fund</b>
Administration expenses (as a proportion of contributions)	~2.8% (participating employers may provide non-financial support)	~5.4% (additional amounts paid to broker-consultants may not be reflected in this figure)
Asset management expenses (as a proportion of assets under management)	~30 b.p.’s (may exclude some performance fees and fees on some investments)	~130 b.p.’s (figure includes charges called ‘guarantee charges’ on underlying smoothed bonus portfolios. See the relevant section in Appendix C for more information)
Trading costs	Mostly included	Probably mostly netted off returns on underlying asset portfolios and hence excluded from above figures. Funds and individuals terminating when smoothed bonus portfolio is over-funded face additional charges, which serve to raise the returns on the underlying asset portfolio for remaining members.

Source: Fund accounts, fund marketing materials

Box 4 illustrates a comparison between a non-commercial umbrella fund and a commercial umbrella fund with roughly the same number of members, although the non-commercial umbrella fund is around five times larger in terms of assets under management. The data come from the most recent fund accounts and fund marketing materials, where applicable. The significant difference between the administration costs of the two funds expressed as a proportion of contributions is striking – although part of the explanation may lie in the greater number of participating employers in the commercial

umbrella fund. However, despite the fact that the commercial fund has billions of Rands under management, its average cost of asset management appears higher than a retail investor would pay for passive investment in South African equities. Two significant factors underlying this may be the guarantee charges in smoothed bonus portfolios, which are significant in this fund, and a large degree of customisation of investment portfolios for participating employers, meaning that the fund is running a large number of small investment portfolios at significant added cost.

## International comparison

Both Australia and the UK have commercial multi-employer similar to South African commercial umbrella funds – called ‘master trusts’ in the UK and ‘corporate master trusts’ in Australia. Both perform the same function as commercial umbrella funds, providing cheaper access to retirement savings for small and medium-sized employers.

**Table 4: International comparisons of costs of for-profit group arrangements, ACA and ACM measure, % of AUM p.a.**

Country	Investment management		Total
	Admin fees	fees	
Australia – corporate master trusts >AUD50m	0.17%	0.54%	0.71%
UK – NOW Pensions	R20 p.m.p.m.	0.30%	-
UK – NEST	1.8% of contributions	0.30%	-

Source: IFSA (2009), [www.nowpensions.co.uk](http://www.nowpensions.co.uk), [www.nestpensions.org.uk](http://www.nestpensions.org.uk).

Unfortunately, the figures for Australia in Table 4 exclude any fees for financial advice, or distribution costs. Tapia and Yermo (2008) report that an ACA cost measure for these types of funds in Australia is around 1.13% of assets p.a., again significantly lower than the South African cost measures reported by Gluckman and Esterhuyzen (2011).<sup>17</sup>

*UK still considering how to avoid conflicts of interest in master trusts*

The UK market for ‘master trusts’ is new and has largely developed in response to auto-enrolment. The UK Government acknowledges the potential advantages of these funds. However, it is still considering how conflicts of interest and other risks can be avoided.<sup>18</sup>

## Draft policy options

In principle, even commercial umbrella funds could offer significant cost savings over non-commercial funds, particularly for smaller funds. These cost savings could be generated by the centralisation of plan functions, including administration, contribution collection and investment. Most employers will only be able to achieve

<sup>17</sup> Note that these figures pre-date the Cooper Review of the Australian Superannuation system, which was partly a response to the high cost of their system.

<sup>18</sup> See page 16 of ‘Reinvigorating workplace pensions’, Department for Work and Pensions, HMSO, November 2012. Available at [www.dwp.gov.uk/reinvigorating-workplace-pensions](http://www.dwp.gov.uk/reinvigorating-workplace-pensions)

suitable economies of scale by joining multi-employer funds of some form.

However, the effectiveness of the current commercial umbrella fund model appears to be compromised by the following factors.

*Issues limiting effectiveness of current umbrella fund model*

- In general, commercial umbrella funds do not operate as ‘pure procurement’ funds in the same sense as non-commercial funds. To function effectively, the market for commercial umbrella funds relies to a large extent on competition between service providers when attracting new business from employers, and on efficient purchasing behaviour by employers.
- Commercial umbrella fund providers have the ability to shift charges between initial and recurring charges. Recurring charges are less visible to customers.
- Despite the fact that, for tax reasons employees may be required in terms of their conditions of employment to join a specified commercial umbrella fund if their employer has signed up to one, in most cases they or their employers often have little or no representation on boards of management. Further, formal disclosure requirements to members are low, although many funds exceed these in practice.
- Intermediaries, who sell these plans to employers, may create their own sets of conflicts since they are paid by product providers. Intermediaries may also allow providers to increase the complexity of their product design, partly to make charges appear more palatable to customers, or even to conceal them, making products hard to compare across providers.

The following policy options could strengthen the governance of umbrella funds to ensure that member interests are kept paramount, to make employers active purchasers of retirement funds, and to increase the degree of competition in the market, by standardising fund design and facilitating switches between funds:

- All the policy reforms listed above in respect of non-commercial funds could be applied to commercial umbrella funds. These could include the default fund requirements, and the cost measurement requirements.
- A process to standardise the charging structures, rather than the charge level, of all umbrella funds could be initiated. Other than risk charges, all umbrella funds could be required to make their charging schedules public, and charge all members according to this schedule. Charges as a proportion of contributions, and as a proportion of assets under management, could be considered as a basis for the schedule. In either case, volume discounts could be incorporated into the schedules.
- Commercial umbrella funds could be subject to special governance provisions, including employer-level management committees with defined rights and obligations, requiring

*Applying non-commercial fund reforms to commercial umbrella funds*

*Standardising charging structures*

*Strengthening fund governance*

member and employer representation on boards of management of all commercial umbrella funds, and disallowing fund rules that have the effect of tying the fund to any particular service provider.

*Requiring auto-enrolment*

- Consideration could be given to requiring employers to auto-enrol all employees into a retirement fund. This may turn employers into active purchasers of retirement funds, rather than entities to whom retirement funds are sold, potentially reducing distribution costs.

*Retirement fund exchange and clearing house*

- A retirement fund exchange could be set up to allow employers to select between different funds easily, without requiring intermediaries. This would serve to reduce distribution costs. This exchange could also serve the purpose of a clearing house, managing contributions to the funds and transfers between them, as well as possibly fund administration. Conditions for listing on the exchange could be set in a way which ensures that these funds are simple and cost-effective, reducing some of the indirect costs of intermediation. The exchange could be fully integrated with the SARS tax collection system, further reducing costs.

*Default fund*

- A default arrangement for employers that do not elect a private fund could be set up to facilitate auto-enrolment. For this purpose, a fund or funds could be created under the PFA and listed on the exchange. These funds could also serve as the default destination for preservation funds and unclaimed benefits.

## 5. Retirement annuity and preservation funds

Membership of retirement annuity funds (RAFs) and preservation funds is usually chosen by individuals rather than by their employers (though some RAFs are being marketed to small employers as an alternative to umbrella funds).

*Retirement annuity market depends on competition between providers, rather than on efficient procurement*

Like commercial umbrella funds, RAFs and preservation funds do not operate on a 'pure procurement' basis. In most cases, either

- the fund's liabilities are wholly underwritten by the sponsor in which case:
  - the fund's only asset is the policy issued to it by the sponsor; and
  - the sponsor and/or entities related to it provide all of the products and services that a 'pure procurement' non-commercial fund would purchase on an 'arm's length' basis); or
- the sponsor and/or entities related to it provides administration, consulting and other services to the fund, although investment management may be passed out to specialists unrelated to it but which may be required to pay commissions in the form of rebates to the sponsor for the privilege.

The RA market requires competition between service providers in order to function effectively, with the same requirements for efficient competition as found in the commercial umbrella fund market.

### ■ Drivers of fund costs and charges

#### Administration

RAFs and preservation funds are voluntary membership funds. As such, they need to be marketed and sold to prospective customers (members). This is a significant driver of both their design and their cost. It also means that the costs of contribution collection and benefit payments are high. Most investment-linked RAFs and preservation funds provide investment choice to members. Some require their members to take the advice of financial advisors, which raises the costs of membership.

*RA's and preservation funds need to be sold to customers, and are administratively intensive*

#### Intermediation

The remuneration of intermediaries in the insurance sector – which covers retirement annuity funds through which retirement annuity policies are purchased – is currently under review by the FSB.<sup>19</sup> As part of this review, the provision by Linked Investment Service Providers (LISPs) of intermediary services in respect of preservation funds will also be examined.

*Intermediary commission is currently being reviewed by the FSB*

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<sup>19</sup> See "Call for contributions: Intermediary Services and related remuneration in the insurance sector", Financial Services Board, 11<sup>th</sup> November 2011.

The FSB is considering the possible implementation of a customer contracted fee basis of remuneration for investment product-related intermediary services, and a corresponding prohibition on the payment of commission or other forms of reward by investment product providers to investment platform providers. International developments in this area, most notably the Retail Distribution Review conducted in the UK, and recent changes in the regulation of financial intermediaries in Australia are being considered.

In some policies, partly to pay distribution costs, contract terms require consumers to make regular contributions, exposing them to serious penalties should they fail to do so.

Historically, these were expressed as early surrender penalties. However, since agreement was reached between the National Treasury and large insurers (the terms of which were recorded in the *Statement of Intent* of 2005 and later incorporated in regulations issued in terms of the LTIA and the PFA), some providers have elected to charge high administration charges and then to 'refund' these to individuals after some years as a 'loyalty bonus'. In some cases, minimum premium terms may exclude low-income savers from memberships of RAFs .

### **Price discrimination**

One factor underlying the complexity of many retail products may be price discrimination by providers who attempt to segment the market into various parts for which different charges can be levied. Examples may be:

- Early surrender penalties marketed as loyalty discounts or refunds on fees;
- The extent of member investment choice (greater choice leads to higher charges);
- Discounts on standard charges offered to members enrolled on the recommendation of preferred distribution channels (that is, financial advisors or groups of financial advisors);
- Complex investment guarantees of various types, which are very difficult for consumers to value (greater use of complex guarantees result in higher charges);
- Other policy features, such as free switches of retirement savings from one investment product to another, minimum premium amounts, and the option to make the policy paid-up, at a cost.

Price discrimination may, in principle, be welfare improving or welfare-reducing. It is welfare reducing if the total quantity sold of the good concerned is reduced, or if the dead-weight costs associated with price discrimination (higher administration and transactions costs, consumer errors) exceed the benefits to consumers. However, the complexity of the charging structures of some RAF's in South Africa is truly startling, especially when compared with the simpler (and cheaper) options on the market, which are usually not sold through intermediaries.

## Investment management

A technical appendix contains a detailed discussion of important features of the market in investment management which are relevant to both retail and wholesale customers. This section summarises the broad features of the appendix.

Although a substantial proportion of marketing materials for retail customers produced by investment managers focuses on past performance, there is little evidence that there is any robust relationship between past performance and future performance for any particular investment manager.<sup>20</sup> Analysis is complicated because investment funds that perform poorly tend to be more likely to be shut down, raising the average performance of funds that survive. In addition, any analysis of long-run performance needs to allow for the degree of investment risk taken on by any manager, since risk and return are related. Investors should treat any analysis of historical out-performance that does not account for these two factors with scepticism.

*Past performance of a particular manager provides little or no information about future performance*

Further, there appears to be little relationship in efficient markets between how much investment managers charge and their investment performance.<sup>21</sup> This can be very difficult for consumers to accept, since most quite reasonably expect more expensive products to deliver better outcomes. Yet modern financial markets are very different from the markets in more tangible products in which most individuals have day-to-day experience. Investment managers today are trading highly standardised securities with other skilled financial professionals. All have a direct financial interest in exploiting any mispricing between different securities, and the cost of trading is lower than it has ever been. Consistently outperforming in such a world is extraordinarily difficult, and getting more so.<sup>22</sup>

*The relationship between charges and investment performance*

Many consumers may choose to diversify their holdings across active asset managers, or be encouraged by their financial advisors to do so. While this approach does diversify the operational risks associated with individual fund managers, it may simply result in a very high-cost passive fund, since the greater the number of underlying asset managers, the more likely that their competing market views in the same asset class will offset one another. An example is shown in Box 5 below. Further, some studies suggest that changing managers regularly based on their past performance –

*The problem with diversifying across active investment managers*

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<sup>20</sup> *The same is not true of asset classes. Equities are expected to outperform bonds in future, as they have done in the past, although at the cost of higher short and long-term risks, and there appears to be some momentum in past performance of securities which should be allowed for when assessing manager performance.*

<sup>21</sup> *However, asset managers may quite legitimately provide different levels of service quality, reliability, and trust, and charge different amounts in respect of these.*

<sup>22</sup> *In fact, in the words of one famous academic in his 2008 Presidential Address to the American Finance Association, active investing “is a negative sum game.”, meaning that active investors, as a group, are predictably worse off than passive investors in the same assets. Kenneth French, Presidential Address, American Finance Association, 2008.*

‘chasing winners’ – is also a strategy which may significantly reduce long-run returns.<sup>23</sup>

*A more effective investment approach*

A much cheaper and more effective alternative for consumers may be to dedicate a substantial amount of effort in selecting an underlying asset allocation, possibly with financial advice, and then to diversify across passive fund managers to implement this strategy for the long term. Yet, in South Africa, the volumes invested in passive retail funds appear to be quite small.

*Possible reasons why passive investment is underutilised in South Africa*

The reasons for this are not clear, but may be related to behavioural factors, such as investor over-confidence or optimism, a bias by intermediaries towards high-fee options, partly caused by sales incentives, , investors’ lack of appreciation of the cumulative nature of apparently small annual fees, and investor beliefs that markets are inefficient.

**Box 5: Naïve diversification: active costs, passive performance? Source: Fund fact sheet**

**Smallish balanced ‘Fund of Funds’**

Portfolio composition:

Value manager A	30%
Value manager B	10%
Value manager C	10%
Value manager D	10%
Value manager E	10%
Value manager F	10%
Value manager G	5%
Value manager H	5%
Value manager I	5%
Cash	5%

Total Expense Ratio: 2.5% (may exclude some indirect trading costs)

‘Value’ managers attempt to identify assets which are under-priced relative to fundamentals. Typically, this would involve purchasing assets which are trading at lower price-earnings multiples, which are generally known as ‘value’ stocks. Historically, in most markets, ‘value’ stocks have outperformed stocks with high price-earnings multiples (called ‘growth’ stocks) although this relationship does not hold in all periods.

Given that this fund diversifies across many different ‘value’ managers, the effect of the discretion granted to any one manager is limited – and any actions taken by one manager are likely to be offset by the actions of the other eight managers.

The end investor may therefore obtain a better outcome after costs with a combination of a low-fee passive index funds with ‘value’ biases, such as RAFI-type funds, which are available in most major markets. Passive RAFI funds are available to South African retail investors at TER’s of around 50 b.p.’s.

This passive option would provide performance that is likely to be close to the active fund under discussion here, but a lump-sum investor in the passive fund would save 10% of his capital over five years in fees.

Source: Fund fact sheet

<sup>23</sup> An illustration of this can be seen by comparing the money-weighted returns of mutual funds with their time-weighted returns. (Money-weighted returns are often much lower). Money-weighted returns are the returns that the average investor in funds actually achieve, while time-weighted returns attempt to normalise for cash-flows into and out of particular funds.



## Performance fees

One important issue in the retail market, and the wholesale market, is performance fees. Investors are often persuaded to accept performance fees on the basis that they align the incentives of investment managers with their investors.<sup>24</sup> In practice, however, there appears to be little reliable evidence that even well-constructed performance fees, described in Appendix C, improve manager performance.

*It is very difficult for consumers to assess the value-for-money of performance fees*

### Box 6: Performance fees: used appropriately?

#### An example of a balanced fund

Asset mix: Equities ~65% Bonds and Cash: ~25% Other: ~5%

Self-reported benchmark: CPI

Self-reported performance target: CPI + 5.5% p.a. (gross of fees)

Fixed fees: ~0.9% p.a.

Performance fees:

Fee hurdle: CPI + 2%

Sharing rate: 15%

Basis: One-year rolling rates

Explanation: The performance fee schedule means that the fund manager will take 15% of the annual return of the fund over CPI + 2% each year.

Comment:

The risk characteristics and return drivers of such a fund are not reflected in the chosen benchmark. Such a fund, largely invested in equities, with no discretion exercised by the investment manager, would be expected in an average year to perform close to its self-reported 'performance target', which is CPI + 5.5%, although with considerably variability from year to year. A mix of JSE, MSCI and other tradable indices, based on the strategic asset allocation of the fund, would reflect the risk and return drivers of this type of fund more accurately.

The performance fee does not refer to either the self-reported 'benchmark' or to the 'performance target'. When performance equals the 'performance target', for example, the performance fee will equal 0.6% p.a., increasing the annual service fee by 70%. Another consequence of the design of the performance fee is that increased volatility of the underlying assets increases the expected present value of the performance fee collected.

This fee schedule appears to lower the headline fixed service fee rate by choosing a relatively low benchmark against which 'performance fees' are assessed. Investors in such a fund may not appreciate the overall effective level of fees being charged, or the relationship between volatility and the quantum of performance fee collected. See the relevant section of Appendix C for details.

Source: Fund fact sheet

Performance fees are extremely complex, and few retail investors have the ability to assess the whether the basis for the calculation of performance fees bears any relation to manager performance. This may give investment managers room to choose inappropriate benchmarks in order to disguise base fees as performance fees, and many do. One example is shown in Box 6. Performance fees may also give investment managers incentives to alter their risk exposure in ways which are prejudicial to investors. In the appendix, criteria by which the performance of asset managers could be assessed and rewarded are discussed.

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<sup>24</sup> One argument against explicit performance fees is that a flat percentage of assets under management is, in effect, a performance fee, since if performance is good, assets under management increase due to natural growth and fund in-flows, increasing fees.

## **Investment platforms**

Most investment-linked RAFs use investment platforms. These are discussed in detail in an appendix to this paper. The advantage of investment platforms is that, in theory at least, they facilitate the distribution and administration of investment management services separately from the provision of these services themselves. Theoretically, they also allow investors to tailor their investment strategies more easily and cheaply to suit their needs.

In practice, the largest investment platforms in South Africa are owned or controlled by financial services providers (FSP's), or groups of FSPs, which also have substantial businesses in – usually active – asset management. This may be one reason why few of these platforms offer passive investment options to consumers.

A disadvantage of investment platforms is that they create layered charging structures. These can be hard to understand for consumers, who in some cases may end up paying for the same services twice or even three times. For example, an individual may pay a financial advisor to allocate assets between different funds on a platform. Among other choices, this advisor may recommend a fund of funds, in which another intermediary collects a fee for allocating funds between different managers. This fund, in turn, may invest in a balanced fund with a discretionary investment mandate, where an asset manager is collecting fees for allocating assets between different asset classes as well as selecting securities within each asset class. In effect, this customer may be paying twice or even three times for asset and fund manager allocation services without even realising it.

Rebates paid between different levels of the investment chain may also make it difficult for consumers to assess exactly how much they are paying, to whom, and for what, and may complicate the disclosure of fees at member level. Rebates may lead consumers to believe that most charges borne by them pay for active investment management, and that administration and intermediary services are provided free. This may be appealing to those who believe that paying more for active investment management guarantees higher returns. One example of layered charges, shown in Box 7 below, illustrates the degree of complexity which these charging structures can attain in practice.

## **Customers**

Individuals who become members of RAFs purchase for-profit voluntary membership retirement funds, such as RAFs or preservation funds, are unlikely to be informed and experienced consumers. Costs of finding out about retirement are high; financial literacy is, on average, low, and individuals are subject to behavioural biases which employers and boards of management, acting collectively, may be able to avoid. Most individual customers are probably unable to calculate the impact of recurring charges on their retirement funds.

Customers may not be very sensitive to charges, for reasons already discussed. This is especially likely to be the case if recurring fees are netted off investment returns and individual customers can be persuaded that higher recurring fees generate higher investment performance.

**Box 7: An example of layered charges: in consumers' best interests?**

Charge type	Amount	Levied by	Notes
<b>First platform fee</b>	Sliding scale based on fund size, starting at ~0.8%+VAT of assets p.a., falling to ~0.25%+VAT of assets p.a.	Administrator	
<b>Trail commission</b>	Up to 1.5% + VAT of assets p.a., negotiated between client and advisor	Administrator, but paid to financial advisor	
<b>Second platform fee</b>	Up to 0.4% + VAT of assets p.a.	Multi-manager, but paid to CIS manager for aggregation services	Together, these two fees total ~1.2% + VAT. Precise breakdown is not disclosed.
<b>Investment fee to multi-manager</b>	Up to 1.10% + VAT of assets p.a.	Multi-manager. Out of this fee, a rebate may be paid to the first platform. No rebate has been prominently disclosed in this case.	
<b>Performance fee to multi-manager</b>	Up to a ceiling which is less than 1% + VAT of assets p.a.	Multi-manager	This is based on a relatively undemanding CPI-based benchmark. Appropriate benchmarks are discussed in Appendix C. This performance fee was only payable from a certain date.
<b>Investment fee to individual managers</b>	Average of ~0.8% + VAT of assets p.a.	Individual asset managers	The precise breakdown of these fees between performance fees and flat investment fees is not disclosed. At some point, the multi-manager ceased paying performance fees to underlying managers and replaced this with a performance fee to themselves.
<b>Performance fees to individual managers</b>	Average of ~0.2% + VAT of assets p.a.	Individual asset managers	

Source: Fund fact sheet, administrator's marketing material

**Disclosure**

Retail disclosure in RA policies is governed by the LTIA if the RAFs are underwritten, as most are. Disclosure of charges is thus very high. The only costs which may not be disclosed are the costs of trading, including Securities Transfer Taxes, if any.<sup>25</sup>

*Levels of disclosure in RA policies are typically high*

<sup>25</sup> The standard ASISA definition of the Total Expense Ratio allows some implicit costs of investment management to be excluded. Many providers, however, choose to include these costs.

## ■ Charges in retirement annuity and preservation funds

Although Davies (2011) examines administration fees in RAFs, he ignores non-administration-related costs (in investment-related costs), which limits the usefulness of his study here. However, he does find that South African RAFs appear efficient at performing administration relative to an international peer group. This does not necessarily translate into good value for consumers, once other charges are allowed for.

*Charges for old-generation RAF's*

Rusconi (2004) and Gluckman and Esterhuzen (2011) calculate *RiY* and *RiMV* for RAFs. However, both papers present figures only for “old generation” RAFs sold by life offices. Comparisons are difficult, given that Rusconi’s work is now over eight years old. However, *RiY* values varied between 2.4 per cent each year and 3.6 per cent annually, depending on term, maturity and issuer. *RiMV* varied between 26% and 41%. These values also assume that ‘old generation’ RAFs are held to maturity. In practice, most are not, and the early surrender penalties levied on individuals probably increase the *RiY* substantially.

National Treasury has performed its own investigation of charges in ‘new generation’ retirement annuity providers. The results of this are shown in Table 5. The same premium escalation and return assumptions as Rusconi (2004) were used.

**Table 5: Reduction in Maturity Values for 20-year ‘new-generation’ RAs and preservation fund policies.**

Provider	RA <i>RiMV</i>	Preservation fund <i>RiMV</i>	Minimum monthly investment	Flexible contributions
A	27.4%	42.7%	R500	Y
B	23.9%	37.6%	R500	Y
C	29.4% (R2 500 p.m.)	44.4% (R250 000)	R2 500	Y
	28.4% (R4 000 p.m.)	42.7% (R500 000)		
D	10.7%	17.6%	R1 000	Y

Source: National Treasury calculations, based on fund marketing materials

For the first two providers, these *RiMV*'s are an improvement over old-generation products. The minimum monthly investment on these products makes them accessible even for individuals at the tax threshold who wish to contribute 10 per cent of their monthly income. The third provider, a life office, appears to represent a step backwards in terms of fees, particularly as far as preservation funds are concerned. It also has a high minimum contribution rate and a sliding-scale charging structure which (slightly) favours larger investments. Presumably, the intention is to protect their higher-cost ‘old-style’ retirement annuity business. The fourth provider does not sell through intermediaries, offers no investment choice, and invests all assets passively. There are no early surrender penalties in these contracts.

## International comparison

Most of the international studies of retirement funds costs have focused on for-profit voluntary membership retirement funds. Results from three studies are shown in Table 6.

**Table 6: International comparisons of costs of for-profit voluntary membership retirement funds, various measures.**

Country	RiMV (Whitehouse, 2000)	RiY (Hernandez and Stewart, 2008)	ACA (Tapia and Yermo, 2008)
<b>Mandatory systems</b>			
Argentina	23%	0.77%	1.3%
Australia‡	35%§	-	2.3%§
Bolivia	9%	0.39%	0.5%
Bulgaria	-	1.20%	-
Chile	16%	0.61%	0.7%
Colombia	13%	0.53%	-
Costa Rica	-	0.92%	2.0%
Croatia	-	0.98%	-
Dominican Republic	-	0.84%	-
El Salvador	18%	0.49%	1.2%
Estonia	-	-	1.5%
Hong Kong	-	1.79%	-
Hungary	-	1.00%	1.9%
Israel	-	0.57%	-
Kazakhstan	12%	-	-
Latvia	-	-	1.4%
Macedonia	-	0.88%	-
Mexico	27%	0.62%	1.7%
Peru	19%	0.63%	1.0%
Poland	18%	0.78%	1.4%
Slovakia	-	0.82%	1.5%
Sweden	14%	-	0.4%
Uruguay	14%	0.51%	0.9%
<b>Voluntary systems</b>			
Czech Republic	-	1.92%	-
Serbia	-	1.86%	-
Turkey	-	2.48%	-
UK (personal)	23%	-	1.6%§
UK (Stakeholder)	20%	-	-

§ IFSA (2009) reports an ACA figure of around 2.0% p.a. for Australian retail funds, slightly lower than Tapia and Yermo (2008). Tapia and Yermo (2008) do not calculate an ACA figure for the UK; the value shown is from IFSA (2009).

‡ This refers to voluntary membership retirement funds within the Australian system. The Australian system is mandatory but most workers are covered through industry-wide or occupational pension plans. Plans are underway to reduce costs in the Australian system.

Source: Tapia and Yermo (2008)<sup>26</sup>, Hernandez and Stewart (2008)<sup>27</sup> and Whitehouse (2000)<sup>28</sup>.

<sup>26</sup> Tapia, Waldo and Juan Yermo, 2008, "Fees in individual account pension systems: a cross-country comparison", OECD Working Paper on insurance and Private Pensions, No. 27.

<sup>27</sup> Hernandez, Denise Gomez and Fiona Stewart, 2008, "Comparison of Costs and Fees in Countries with Private Defined Contribution Pension Systems", International Organisation of Pension Supervisors, Working Paper No 6, 2008.

<sup>28</sup> Whitehouse, Edward, 2000, "Administrative charges for funded pensions: An international comparison and assessment", Social Protection Unit, World Bank, Washington D.C.

Comparison with Table 1 indicates that the South African ‘old-generation’ RA products appear to perform worst by a substantial margin. ‘New generation’ products perform better, although there is substantial heterogeneity in the fees charged. While most of the systems examined are mandatory, fund membership in most of these systems is voluntary, since individuals typically choose which funds to join.

Table 6 illustrates well, though, the difficulties of comparing costs across different countries. Each of the three papers quoted calculates a different measure of cost, and the values obtained are sometimes inconsistent. While the two sets of values are closely correlated, Hernandez and Stewart find values that are on average about half the magnitude of those found by Tapia and Yermo (2008). Although the larger values appear more consistent with Whitehouse (2000), after correspondence with the authors of two papers, it was decided to emphasise the lower values.<sup>29</sup>

*Difficulties in comparing costs across countries*

However, the following factors limit the applicability of the comparison:

- Most of these systems are mandatory, and have full preservation, which significantly raises average balances; of the voluntary systems (Serbia, Czech Republic, Turkey, UK, US), the South African system appears to fare worst, on average, except for Turkey. It should be noted, though, that in most mandatory systems, membership of a *particular fund* is voluntary, and funds consequently engage in significant amounts of marketing to attract customers.
- The charge measures listed for some systems (Czech Republic, Bulgaria, Hungary, Croatia) include portfolio guarantees, which are not included in the charge ratios of the South African system, making the South African charge ratios appear yet worse.
- Many systems may invest more in bonds than the typical South African fund, making their system appear cheaper.
- South African retirement funds, including RAFs, pay Securities Transfer Tax on direct equity investments, which may increase costs relative to their peers in other countries where such taxes are not levied.
- Costs have fallen in many countries, including in South Africa, since these studies were compiled.

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<sup>29</sup> Both sets of authors worked for the OECD at the time the papers were written. The differences between Whitehouse (2000) and Hernandez and Stewart (2008) were explained by falls in charges over the period, while the differences between Tapia and Yermo (2008) and Hernandez and Stewart (2008) were due to the fact that the first paper used a contemporaneous ACA-type measure, while the second was a forward-looking RiY measure using a standardised methodology across countries. Differences therefore reflected, in part, the immaturity of most of the systems being examined.

- The figures shown here represent averages across the industry in each country, which masks varying degrees of heterogeneity. In South Africa, the US, the UK and Australia, the degree of heterogeneity is probably higher than average because of the voluntary nature of these systems, the relative lack of product regulation or investment restrictions and the various distribution channels under which they operate.
- Some systems have functions which are performed centrally (for instance, Sweden, Bolivia and Latvia operate central clearing houses, while Poland, the Slovak Republic, Macedonia, Croatia and Bulgaria have central agencies which collect contributions).
- Many of these countries are smaller than South Africa, and their systems are less mature, which should favour the South African system.

## ■ Draft policy options

In principle, RAF's should be a last resort for retirement provision for the self-employed or those who wish to make additional retirement provision over and above that provided by employer-based funds. Few RA funds currently provide risk benefits.

### Recommendations

The following possible reform options are suggested:

- RAFs could be made subject to the same default option requirements as is proposed in relation to the other two funding channels. *RAF's could be required to provide a default option*
- Consideration could be given to regulating the types of charges approved RAFs are permitted to levy on the same basis as those levied by commercial umbrella funds and non-commercial funds may be subject to regulation. Permitted charges may include a fraction of assets under management, and a fraction of contributions. Volume discounts may be permitted. In the formulation of these policy proposals, performance fees will be examined closely. Early surrender penalties, loyalty discounts and other forms of price discrimination could also be prohibited. *Types of charges could be restricted*
- The Retail Distribution Review currently underway by the FSB will be supported, particularly as concerns rebates paid by investment platforms. *Investment platforms will be investigated further*
- Intermediaries who promote membership of RAF funds that mirror the default DC fund described in the previous section, in their contribution and benefit design, and that comply with conditions relating to charges, could be exempted from compliance with FAIS for the purpose, provided that the retirement savings of all members enrolled in these circumstances are invested in the default investment fund. *Exemption from FAIS for qualifying RAF's*

## 6. Conclusion

This paper presents the initial findings from the research conducted by the Treasury on costs and charges in the retirement industry. The Treasury recognises that key stakeholders in the retirement fund industry be afforded the opportunity to comment on the analysis, and to engage with the conclusions and draft findings stated below. While the findings have been used to suggest some tentative draft policy proposals, these are mainly intended to facilitate and structure intensive engagement with stakeholders around the analysis performed and possible policy actions. These draft proposals will only be finalised once the engagement process with key stakeholders has been completed.

### ■ Draft findings

The following are the main findings of the analysis:

*The South African system appears to be expensive*

- Structural factors – including the large number of retirement funds, the voluntary nature of the system, which has implications for design, cost and complexity, and the low rate of preservation in South Africa – are significant drivers of the costs of the South African retirement system, which appears to be expensive in an international context. Higher rates of preservation, a smaller number of funds, and greater participation in the system, if well managed and regulated, could lower costs. The level, and quality, of employment will also affect coverage, and hence the level of costs.

*Minimum disclosure levels in non-commercial funds and umbrella funds are low*

- Charges vary between funds of different types, both in terms of the overall level of fees and in their complexity. The charge structures of funds that are established to sell the services of their commercial sponsors and related parties are often exceptionally complex, making different types of plan and different options within each plan very hard to compare.
- The required level of charge disclosure to members in both non-commercial retirement funds and commercial funds, is low. Yet in many cases, members are automatically enrolled into these funds as a condition of employment. However, increased disclosure is unlikely to be sufficient on its own to achieve lower costs.

*Customers are unlikely to be sensitive to charges, especially recurring charges which reduce their benefits in many years' time.*

- Customers may be insensitive to the level of charges in their retirement funds. This may be especially true of recurring charges which are netted off investment returns, since these charges serve to reduce benefits which are received many years in the future. Many investors may also believe – probably mistakenly – that higher investment returns will compensate them for higher recurring charges.

*Charges are often shifted from initial charges to recurring charges*

- As a consequence, there appears to be a broad tendency in all types of retirement fund to shift charges away from up-front



charges based on contributions, to recurring charges expressed as a proportion of assets under management. Recurring charges may be less visible to customers than initial charges for a variety of reasons.

- Recurring charges may be shifted between investment-related, performance fees, guarantee charges, platform fees, administration fees and advisor fees in order to make the overall level of charges appear more palatable to consumers. Shifting may be implicit, or explicit, achieved through the payment of rebates, or through highly layered charging structures.
- A preference for active management on the part of consumers and – crucially – intermediaries, may raise the investment-related costs of retirement funds above the lowest attainable levels, particularly for retail investors.
- Financial intermediaries, including retail agents and brokers, wholesale brokers, advisors and investment platforms, play a valuable role in bringing buyers and sellers of products and services together, and in some cases, by providing financial advice in order to improve consumer decision-making. However, intermediation of all types may have the unintended consequence of raising the complexity of retirement fund designs as well as their cost.
- Investment platforms, and the layered charging structures they create, add complexity as well as cost to retirement funds. The payment of rebates between investment managers, platforms, and possibly other intermediaries creates conflicts of interest whose effect may be to raise the overall level of charges paid by consumers. In some cases, consumers may even be paying twice or three times for the same services.

*Recurring fees may be shifted between fee types*

*Prevalence of active management raises fees*

*Unintended consequences of intermediation*

*Conflicts in investment platforms*

## ■ Draft policy options

Various proposals to improve the efficiency of the retirement system include:

### *Encouraging fund consolidation*

Most existing retirement funds do not have the necessary size to achieve sufficient economies of scale, which leads to higher costs and lower benefits for members. Achieving sufficient economies of scale while retaining distribution through the workplace will require a broad move towards multi-employer arrangements.

*Proposals to improve the efficiency of the retirement system*

*Fund consolidation should be encouraged*

### *Improving fund governance*

Although the process of strengthening fund governance has already started with amendments to the PFA in 2013, more needs to be done. For instance the act, or a directive issued in terms of the act, may make explicit the duties of trustees in regard to the fund and the members, and ensure that funds fulfil their objectives cost-effectively. Other options may be to require all boards, in line with King III governance practices, to have some independent and/or

*Fund governance, particularly umbrella funds, should be strengthened*

expert trustees, to require employer and member-elected trustees on the boards of all multi-employer funds, and to formalise the role, rights and obligations of employer-level committees in such funds.

#### *Strengthening fund regulation*

*Fund regulation should be strengthened*

A strong and effective regulator is essential in ensuring a well-functioning retirement system. The regulator needs to have the power to effectively monitor all aspects of the retirement system, including costs, and the power to intervene where necessary to protect the interests of members. These powers will be conferred by statute as part of the move to twin peaks financial regulation, and will be aided by an acceleration of the consolidation of funds. The regulator may also consider issuing standardised fund rules and other documents in order to assist funds in managing their relationships with members and service providers.

#### *Retaining the role of the workplace*

*The role of the workplace should be retained*

Given the higher costs associated with individually-distributed arrangements, and the low degree of financial sophistication of the South African workforce, it is recommended that the primary place where retirement savings products are distributed remain the workplace. Reliance should be placed on reforming fund governance, portability of benefits between employers, and, where appropriate, design, in order to ensure that members' interests are protected and that tax incentives granted to members who save for retirement are used appropriately for their benefit.

#### *Simplifying plan design*

*Plan designs should be standardised as far as possible*

In order to increase competition based on price, a significant simplification of the design of retirement products permitted to qualify for tax exemption is being considered. This may imply a standardisation of permitted charging structures, a requirement that all fund members be charged on the same basis, and a restriction on the investment options, if any, which all funds may offer their members, to those compliant with prescribed standards. Volume discounts, either at employer or employee level, may be permitted. Performance fees, in particular, will be examined closely. Plans which grant member investment choice may be required to have suitable default investment portfolios, which must meet more stringent requirements, including possibly a cap on recurring charges. This is intended to limit the ability of providers to shift charges onto recurring charges.

#### *Ensuring effective intermediation*

*Intermediaries in the group space should be remunerated in a way which aligns their interests with those of customers*

While intermediation of all types is important, it can be expensive, and may be conflicted by remuneration structures. Work is currently underway in the retail space to explore ways in which the remuneration of intermediaries may better align their incentives with customers. This review will be expanded to include intermediary remuneration in the group retirement space. Various aspects of investment platforms, including the payment of rebates by

investment managers to platform providers, will be also be investigated.

#### *Mandating enrolment into retirement funds*

A significant driver of the cost of private funds is the need to distribute them to individuals. To reduce these costs, one option may be to require employers to automatically enrol their employees into a retirement fund, which may be a stand-alone pension fund, an umbrella fund, or a retirement annuity fund.

*Mandating participation in a retirement fund should be considered for all workers*

#### *Creating a retirement fund exchange or clearing house*

One option to ensure that auto-enrolment is effectively implemented, may be to create an exchange that allows smaller employers and their employees to compare different plans easily, and to choose one which meets their needs, without their requiring financial advice. Funds which satisfy certain criteria, including scale, design, efficiency and simplicity will be permitted to list on the exchange. Further cost reductions may be obtained through allowing the exchange to operate as a clearing house, centralising contribution collection and possibly fund administration, and automating the process of switching between plans. The clearing house may be integrated with the SARS tax collection system, as in the case of the KiwiSaver program in New Zealand.

*A centralised clearing house could significantly reduce the overall level of administration and distribution costs*

#### *Establishing a default fund*

Another requirement for effective auto-enrolment is that there be a default fund for those employers who do not specify a fund themselves. One option for this may be a specific fund or funds set up for this purpose, to be regulated under the PFA and listed on the exchange. These funds may also serve other functions, such as facilitating preservation and ensuring the effective management of unclaimed benefits.

*A default fund should be established to ease auto-enrolment*

## 7. Comments

The public is invited to comment on the draft proposals contained in this discussion document by no later than **30 September 2013**. Comments may be submitted to:

Attention: Dr David McCarthy, Retirement Policy Specialist, Private Bag X115, Pretoria, 0001. Or by fax to 012 315 5206; or by email to [retirement.reform@treasury.gov.za](mailto:retirement.reform@treasury.gov.za).

Further consultations will be held once the proposals are refined and during the legislative process. Consultative meetings will also be convened with trade unions, employers, retirement funds and other interested stakeholders.

The paper released by National Treasury on 14 May 2012 titled *Strengthening retirement savings: An overview of proposals announced in the 2012 Budget*, ([http://www.treasury.gov.za/comm\\_media/press/2012/2012051401.pdf](http://www.treasury.gov.za/comm_media/press/2012/2012051401.pdf)) listed the following technical discussion papers for release during the course of 2012:

A. *Retirement fund costs* – Reviews the costs of retirement funds and measures proposed to reduce them.

B. *Providing a retirement income* – Reviews retirement income markets and measures to ensure that cost-effective, standardised and easily accessible products are available to the public

C. *Preservation, portability and uniform access to retirement savings* – Gives consideration to phasing in preservation on job changes and divorce settlement orders, and harmonising annuitisation requirements. The aim is to strengthen retirement provisioning, long-term savings and fund governance

D. *Savings and fiscal incentives* – Discusses how short- to medium-term savings can be enhanced, and dependency on excessive credit reduced, through tax-preferred individual savings and investment accounts. It also discusses the design of incentives to encourage savings in lower-income households.

E. *Uniform retirement contribution model* – Proposes harmonising tax treatment for contributions to retirement funds to simplify the tax regime around retirement fund contributions.

All papers have now been released and are available on the National Treasury website ([www.treasury.gov.za](http://www.treasury.gov.za)). Note that paper A is the current document under a different title, paper B above has been renamed as *Enabling a better income in retirement*. Paper D was renamed *Incentivising non-retirement savings*, while Paper E also has a different title, *Simplifying the tax treatment of retirement savings*.

# A

## Alternative measures of charges

There are several methods of measuring charges in DC pension systems in common use. Some are lifetime measures, which measure the impact of fees over the whole membership of an individual in a particular retirement vehicle, and some are accounting-based measures of annual charges. Both types of measure struggle to account for charges which are conditional on either member actions (such as withdrawal, retirement or making a contribution) or investment returns (such as performance fees or guarantee charges).

### *Lifetime charge measures*

The two most commonly-used lifetime charge measures are the reduction in yield (*RiY*), which shows the effect of charges on the rate of return, given a set of assumptions; and the charge ratio, or reduction in maturity value (*RiMV*), which measures the extent to which final benefits are reduced by the imposition of charges relative to a hypothetical balance in a similar plan had no charges been levied.<sup>30</sup>

*Reduction in Yield and  
Reduction in Maturity Value*

Both are prospective measures, which require assumptions about length of membership, future investment strategies, charging structures and contribution amounts, to name but a few. The measures are only accurate to the extent that the assumptions made are borne out in practice. Further, by changing the assumptions, the outcome may be manipulated. In principle, these measures should be calculated on an individual level, rather than on a fund level, as there may be significant differences between individuals in different circumstances even in the same fund.

There is a close, but not exact, relationship between *RiY* and *RiMV*. For instance, for a regular level premium policy which lasts for *T* years, with no fixed costs or charges at inception, the following approximation is valid if *RiY* is small:

$$RiMV = 1 - RiY * T/2.$$

However, if there are fixed costs (e.g. at inception, or with each monthly premium), if premiums or charges vary over the term of the policy, or if saving patterns are interrupted, then the two measures are no longer equivalent. Greater emphasis is placed on the *RiMV* as this is less abstract for long-term savers than a reduction in yield

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<sup>30</sup> See Whitehouse, Edward, 2000, "Administrative charges for funded pensions: An international comparison and assessment", World Bank & Axia Economics.

since it emphasises the impact of charges on the ultimate portfolio value.

Typically, as the term of an investment increases, the *RiY* falls, and the *RiMV* rises. This is because as the term off an investment increases, investment management charges begin to dominate.

Finally, most models used to measure lifetime charges are deterministic, and so cannot be used to assess conditional charges.

#### *Accounting-based measures*

*Accounting cost per assets and per member, and Total Expense Ratio (TER)*

Since lifetime charge measures are so difficult to calculate, international comparisons often rely on annual charges taken from fund accounts. These simply express the total amount charged by a particular fund (or group of funds) in fees either as a currency amount per member per year, or as a percentage of assets under management per year.

These measures are called accounting cost measures, either per member per year or as a proportion of fund assets per year, and denote them *ACM* (per member) and *ACA* (per fund assets).

The *ACA* measure is most similar to the Total Expense Ratio (*TER*), which is required to be reported by CIS's. The standard definition of the *TER* excludes some trading costs, including stock broking fees, bid-offer spreads, if any, and Securities Transfer Taxes, if applicable. A comprehensive *ACA* measure would include these.<sup>31</sup>

Accounting measures also struggle to deal with conditional charges, because the amount of the charge in any year will depend on whether the event triggering the charge occurred or not. In a year when conditional charges are high, accounting-based measures will overstate the average level of charges, and the opposite will be true when conditional charges are low.

The relationship between accounting measures and lifetime measures is not simple. In principle, the *ACA* measure is similar to an *RiY* measure, provided the assumption is made that the costs of the fund are spread between members in proportion to their assets under management, that the fund costs as a proportion of assets will be stable over the membership period of the individual, and that there are no conditional charges. None of these is likely to be true in practice.

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<sup>31</sup> Some providers choose to include these implicit costs in their reported *TER*'s.

# B

## International approaches to reducing retirement fund charges

This appendix describes approaches adopted in different countries to reduce retirement scheme charges. Since the introduction of mandatory individual account DC pension systems, there has been substantial concern that the level of charges has not fallen as far as would be expected in a fully competitive market.

While each country has unique circumstances and has pursued its own approach to charge reduction and regulation, following Rusconi (2007),<sup>32</sup> the measures adopted can be divided into four broad categories, listed in decreasing order of the degree of intervention in the operation of the market, including:

*Types of measures to reduce charges*

- Direct or coercive. These may include setting charge types and maximum charge levels, requiring regulator approval of all charges, or negotiating charges across the entire industry.
- Incentivized. This method applies explicit interventions which reward low charges (or good net performance).
- Structurally facilitative. The structure of the industry is designed to ensure that low charges develop naturally. Approaches include regulating fee types, standardising products through product regulation and using clearing-houses to centralise the costs of contribution collection.
- Supportive. Other, less interventionist methods, of reducing charges, such as increased disclosure.

This paper first discusses general attempts to reduce charges across OECD countries, and then focuses on a selected group of countries in more detail.

### ■ Restrictions on types and levels of charges

Most jurisdictions around the world impose some form of fee regulation on (usually mandatory) individual-account DC pension systems. These include regulating the type of fees permitted,

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<sup>32</sup> Rob Rusconi, 2007, "South Africa's Mandatory Defined Contribution Retirement Saving System: Provider Accreditation" contained in "Reform of Retirement Provision: Feasibility Studies", September 2007, Department of Social Development.

regulating the level of fees, or requiring all fees to be pre-approved by the regulator.

Table B1 contains a list of permitted fees, and fee limits in selected countries. Countries that follow what might loosely be called the Anglo-Saxon charging model (the UK, USA, Australia, Ireland, and South Africa) impose virtually no limits on fees, besides some small exceptions. These countries rely heavily on the market mechanism to regulate fees.

**Table B1: Limits on fees in individual account DC pension systems. A zero limit indicates a fee prohibition.**

Country	Fee limits on contributions	Fee limits on assets under management	Fee limits on returns p.a.	Fixed fee limits p.a.
Argentina	1% of salary	0%	0%	0
Australia	No limit†	No limit†	No limit†	No limit†
Bolivia	0.5% of salary	0.2285%	0%	0
Bulgaria	5% of contributions	1%	0%	BGN20
Chile	No limit	0%	0%	No limit
Colombia	3% of salary*	0%	0%	0
Costa Rica	4% of salary	0%	8%	0
Croatia	0.8%	0.95%	0%	0
El Salvador	3% of salary*	0%	5%	0
Estonia	3% of salary until 2007	2%	0%	0
Kazakhstan	0%	0.05%	15%	0
Ireland	No limit	No limit	No limit	No limit
Israel‡	6% of contributions	0.50%	0	0
Latvia	2.5% of contributions until 2006	0%	0%	0
Mexico^	No limit	No limit	0%	0
Peru	No limit	0%	0%	0
Poland	7% of contributions (3.5% by 2014)	0.54%	0.06%	0
Serbia	3% of contributions	2%	0%	0
Slovakia	1% of contributions	0.78%	0%	0
South Africa	No limit	No limit	No limit	No limit
Sweden	0%	No limit	0%	0
Turkey	8% of contributions	3.65%	0%	0
UK (personal)	No limit	No limit	No limit	No limit
UK (Stakeholder)	0%	1%§	0%	0
Uruguay	No limit	0%	0%	No limit
USA	No limit	No limit	No limit	No limit

\* This includes risk benefits

† Special provisions apply to account balances less than AUD1000

§ 1.5% for the first 10 years

‡ Figures refer to 'new-style' pension funds

^ Fees must be approved by the Pensions Board

Source: Tapia and Yermo (2008)<sup>33</sup> and Hernandez and Stewart (2008)<sup>34</sup>.

The majority of countries in this sample restrict both the maximum level, and the type, of fees. Some countries restrict the type of fees, but not their level, in order to ensure that charging bases are sufficiently comparable between different providers.

<sup>33</sup> Tapia, Waldo and Juan Yermo, 2008, *Fees in individual account pension systems: a cross-country comparison*, OECD Working Paper on insurance and Private Pensions, No. 27.

<sup>34</sup> Hernandez, Denise Gomez and Fiona Stewart, 2008, *Comparison of Costs and Fees in Countries with Private Defined Contribution Pension Systems*, International Organisation of Pension Supervisors, Working Paper No 6, 2008.



## ■ Other methods of reducing charges

In most of the countries in the table, the product design of retirement funds is regulated in order to ensure that products are comparable across providers. This is particularly true in mandatory individual-account DC systems.

Product regulation may include the type, level and conditions applied to risk benefits, the number and type of investment portfolios offered to individuals, the conditions under which individuals may switch from one provider to another, and the legal design of retirement funds themselves.

*Product regulation*

Some countries facilitate competitive bidding processes for asset management and risk benefits centrally. This approach is used in Chile, for the risk benefits offered by their providers, in Bolivia for asset management, in the Thrift Savings Plan (an occupational plan for employees of the US Federal Government) for asset management, and for asset management in the publicly-run National Employee Savings Trust (NEST) in the UK.

*Facilitated competitive bidding*

In Chile and Mexico, a mechanism periodically selects the lowest-cost provider and automatically allocates new labour-market entrants to that provider unless they elect otherwise. This is an attempt to incentivise low charges and to lower the cost of entry for new providers.

*Account allocation mechanisms*

Other countries, most notably Sweden and Bolivia, rely on centralised contribution collection through a clearing house in order to reduce charges.

*Clearing houses*

Yet other countries rely on high levels of disclosure. Australia, for instance, has one of the toughest disclosure regimes in the world. Despite this, parts of their system have some of the highest charges in the world. In some countries, such as Mexico and Argentina and, until recently, the United Kingdom, Government agencies report the charge levels of different providers to the public to ensure a consistent and reliable approach to charge measurement.

*Disclosure*

## ■ The United Kingdom

Following the report of the Pensions Commission chaired by Lord Adair Turner in 2005, the United Kingdom has embarked on a wide-ranging reform of its pension system, focused on improving low participation rates and lowering average charges.

The main change has been the introduction of a requirement on employers to automatically enrol their employees into a retirement scheme. Employees are subsequently free to opt out of participating in this scheme if they wish. Auto-enrolment commenced on 1 October 2012, and will be introduced in phases. Employers are required to contribute at least 1 per cent of employees' salaries into schemes, rising gradually to 3 per cent over the next few years.

*Introduction of auto-enrolment*

In tandem with the introduction of auto-enrolment, the UK has created a Government-run pension scheme, called the National

*A Government DC pension scheme, called NEST*

Employment Savings Trust (NEST), which qualifies for auto-enrolment. NEST has extremely competitive charges of 1.8 per cent of contributions and 0.3 per cent of assets under management each year.

There are two unusual features of this pension reform, which may limit its effect on reducing charges in the long run. Firstly the choice of the retirement vehicle into which employees are to be auto-enrolled is exclusively the choice of the employer, yet there is no regulation of the division of costs between employer and employees. The reform thus relies on the willingness and ability of employers to select low-cost retirement funds for their employees. Secondly, despite the fact that NEST was introduced to solve a perceived failure in the market for retirement provision, the restrictions placed on the operation of NEST are extremely onerous. Employees may not transfer pension accounts accrued outside NEST into NEST, and yearly contributions to NEST may not exceed £4200 (~R60 000) for any employee.<sup>35</sup>

*Private-sector response to NEST*

The private sector has responded to the introduction of NEST by introducing competitively-priced offerings to compete for the pool of auto-enrolled employees. These typically offer no investment choice, and have annual charges broadly equivalent to those of NEST.

In response to a challenge from the UK Pensions Regulator (tPR), the National Association of Pension Funds (NAPF) has released a draft code of conduct for charge disclosure in DC pensions.<sup>36</sup> This code discusses how charges should be disclosed to employers at the point that employers select a pension plan for their employees in terms of the auto-enrolment legislation. The code includes a recommendation for a 2-page disclosure to employers of charges and services to be provided by the fund, which incorporates a measure similar to the *RiMV* discussed earlier in this paper.

tPR is currently engaged in an exercise to shape the regulatory framework for occupational DC funds. In its work, it has already acknowledged the complexities created by ‘master trusts’, its term for commercial umbrella funds.

In addition, the House of Commons Committee on Work and Pensions has held hearings into the likely effect of auto-enrolment and the introduction of NEST on pension provision in the UK. Part of this report deals with the issue of charges in pension funds, and how they can be reduced. The report recommends that the restrictions imposed on NEST be relaxed, currently the subject of a Government consultation, and considers charge regulation should the industry fail to develop a standard charging basis on its own.

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<sup>35</sup> *The Government has issued a consultation on whether these restrictions should be relaxed.*

<sup>36</sup> *“Telling people about DC pension charges”, National Association of Pension Funds, 2012. [http://www.napf.co.uk/PolicyandResearch/DocumentLibrary/0254\\_Telling\\_people\\_about\\_DC\\_pension\\_charges.aspx](http://www.napf.co.uk/PolicyandResearch/DocumentLibrary/0254_Telling_people_about_DC_pension_charges.aspx)*

The Office for Fair Trading (OFT) has launched an investigation into the competitiveness of the DC retirement industry in the UK, which should report shortly. The Department for Work and Pensions (DWP) has also recently launched a consultation on the feasibility of a cap on charges in default options.

## ■ **Australia**

The Australian superannuation (pension) system was created in the mid-1980's, when it first became mandatory for employers to select a pension fund on behalf of their employees and to make contributions into that fund on their behalf (called the Superannuation Guarantee (SG)). Currently, 9 per cent of salary is contributed; it is proposed to increase this to 12 per cent by 2017.

Its mandatory nature aside, there are strong similarities between the South African and Australian systems. Both have a wide variety of institutions: standalone employer funds; corporate master trusts (very similar to South African commercial umbrella funds); retail master trusts, (very similar to RAF's), and union or sector funds (similar to South African union, bargaining council or sectoral determination funds). The vast majority of these funds are now DC rather than DB, although DB funds still account for a substantial fraction of the assets under management. As in South Africa, there are virtually no restrictions on either the design of Superannuation products or on the type or level of charges which may be levied. In June 2009, assets under management in the system stood at AUD1.1trn (R11 trn). In real terms, this is expected to treble by 2035. The system is therefore highly significant economically.

*Similarities between the South African and the Australian systems*

Despite the fact that Australia has one of the toughest disclosure regimes in the world, there has been substantial concern over the high level of fees in parts of their system. As a response, in 2009, the Government tasked the Cooper Review with providing a comprehensive analysis of the governance, efficiency, structure and operation of the Australian system, and outlining possible options for reform. The Review reported its findings in June 2010.<sup>37</sup>

*Cooper Review as a response to perceived high charges*

The review found that:

- Member interests are not always paramount
- Fees are too high, and have not reduced in line with what the available economies of scale might have suggested
- The regulatory model has focused on prudential aspects, but has not dealt explicitly with efficiency
- There is too much complexity and too little transparency and comparability in the system
- The emphasis on disclosure and member choice has not led to efficient outcomes for a substantial portion of the member population
- Past performance data is given too much prominence

*Findings of the Cooper Review*

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<sup>37</sup> More information is available at <http://www.supersystemreview.gov.au/Default.aspx>.

*Australian market competition has not led to lower charges*

The review also found that normal consumer demand-led competition has not led to a competitive market which reduces costs for members because:

- Many members fail to exercise choice. 80% of members choose the default fund.
- Costs do not come directly out of members' pockets, but rather out of their benefits, making people much less price aware and less likely to make decisions based on cost.
- Many members are not interested in their pensions until they approach retirement.
- Agency problems may deprive members of opportunities to exercise choices which reduce prices.
- There is a lack of comparability of different products owing to high complexity, a lack of information and transparency about fees and performance.
- Frictions may prevent individuals from changing funds even if they want to.

*Characteristics of MySuper*

The main recommendation was to introduce a new class of no-choice retirement funds, called MySuper. Fund administration will also be streamlined through a package of measures called SuperStream.

#### *MySuper fund governance*

The Trustees of MySuper funds will be given duties that are principles-based, in particular:

- Optimising investment performance and overall cost to members.
- Not being permitted to delegate investment choices to members.
- Optimising operating costs in the best interests of members, including obtaining appropriate scale.

#### *MySuper fund distribution*

Employers may only default members into funds which qualify as MySuper entities. Members who wish to do so, may, though, elect a 'choice' architecture giving them greater personal responsibility for their superannuation.

#### *MySuper fund design*

MySuper funds:

- May not pay up-front or trail commissions.
- May not charge entry fees.
- May charge exit fees and switching fees only on a cost-recovery basis, to the fund rather than to the management company.
- May not offer investment choice.
- May not cross-subsidise the costs of MySuper products and other products.

- May only pay performance fees to investment managers under strict conditions.
- Must be benchmarked to one another according to a transparent methodology on a consistent and objective basis.

#### *MySuper fund advice*

MySuper funds would be required to provide financial advice to members on matters relating to their MySuper balance (primarily related to retirement and opting out of fund insurance).

Notably, the review did not recommend mandatory passive investment management (it outlined the arguments in favour of passive investment management, but gave trustees the sole responsibility for determining suitable investment strategies). It also did not recommend charge caps, although the types of charge were limited. A centralised clearing house approach for superannuation products was outside its mandate.

The Government has decided to implement the recommendations of the Review. Draft legislation was released from February 2011, with the core MySuper Bill released for comment in June 2011. The first enrolment into MySuper products will commence in June 2013.

# C

## Economics and finance of investment management

In this section issues related to the economics of fund management are discussed, starting with active and passive investment management, and various approaches to diversification. There follows an analysis of performance fees, smoothed bonus products, and investment platforms – an important issue for commercial umbrella funds and voluntary membership retirement funds.

### ■ Active and passive investment management

Active investment management broadly refers to funds which seek to identify under-priced assets in the hope that they will outperform their peers. Passive, or index-tracking, investment managers simply try to replicate the return on the benchmark they are tracking. Since there is little judgement involved and little trading, passive management is much cheaper than active management. Over the long run, the fee saving compounds and becomes substantial.

*Market averages are defined as the outcome of the average investor, active or passive*

By definition, the “average” investor, whether active or passive, can only perform in line with the market. Half of funds invested will underperform the market in any given year, and half will over-perform. Together, they make up the market. After expenses, the “average” investor must therefore underperform the market. The presence of a large body of investors who over-perform requires, as a mathematical condition, the existence of a corresponding group who under-perform, provided that the benchmark is correctly specified.<sup>38</sup>

*The requirements of the case for active management*

The case for active management is built on the idea that over-performing managers exhibit consistent over-performance – *i.e.* that past manager performance is a guide to future performance – and that future outperformers can easily be identified. In the absence of either one of these two conditions, the case for active management falls down.

In practice, there is a broad range of approaches between fully active and fully passive. Even passive investors must select an asset allocation and an index to track, both of which are active choices, and many indices are constructed on bases other than market

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<sup>38</sup> A world in which all active managers consistently outperform is rather similar to Garrison Keillor’s fictional town, Lake Wobegon, where ‘all the children are above average’.

capitalisation, allowing passive investors to exploit potential asset mispricing at low cost.

*International evidence on active investment management*

Two important issues are often overlooked when examining historical fund returns. Funds which underperform are less likely to survive than funds which over-perform. Analysis which examines only funds that are currently trading therefore tends to overstate historical fund performance (this is called ‘survival bias’). Also, to outperform benchmarks, many funds may take on extra risk<sup>39</sup>, and the effect is significant enough to make a substantial difference when analysing historical returns. Investors should view any analysis of historical manager outperformance which does not correct for these two factors with scepticism.

*Adjusting historical returns for survivor bias and risk*

**Table C1: International comparisons of abnormal performance in mutual funds.**

Country of fund domicile	Proportion of mutual funds reporting positive:	
	benchmark-adjusted returns (net of expenses) ‡	four-factor benchmark-adjusted performance (net of expenses) §
Austria	48.6	42.6
Belgium	44.1	38.2
Canada	39.2	37.0
Denmark	49.9	37.4
Dublin (offshore)	41.9	30.6
Finland	51.8	36.1
France	52.2	41.3
Germany	51.0	42.6
Ireland	51.4	33.5
Italy	44.9	40.3
Luxemburg (offshore)	45.0	33.3
Netherlands	54.6	46.5
Norway	51.2	40.0
Poland	34.8	53.0
Portugal	52.3	36.2
Spain	37.0	34.7
Sweden	54.7	48.7
Switzerland	32.3	30.9
UK	48.2	35.7
USA	47.5	34.5
Asia-Pacific	49.4	36.2
Total	46.7	36.2

‡ This column shows the proportion of fund-years in which funds in each country outperformed their chosen benchmarks.

§ This column shows the proportion of fund-years in which funds in each country outperformed their chosen benchmarks, after controlling for the risk the funds took in their portfolios, using a standard four-factor procedure. The four factors used are market returns, size (smaller firms typically outperform larger ones), book-to-market (value firms outperform growth firms), and momentum (there is some persistence in individual stock returns).

Source: Cremers et al (2011)

<sup>39</sup> There are several known sources of outperformance which appear to be persistent over time. Examples are the ‘value’ premium, the ‘size’ premium, and the momentum effect. Where these sources of outperformance can be consistently replicated by investors after transactions costs, in efficient markets they must reflect some underlying risk associated with the source of outperformance.

*Why markets for investment management differ from other markets*

Broadly speaking, despite a large number of studies over many years, statistically robust evidence in favour of the persistent outperformance of active managers is weak, after taking these factors into account.

One example of an analysis of international asset managers which does control for survivor bias and the underlying risk of the portfolios – as measured through a standard four-factor procedure – is shown in Table C1.<sup>40</sup> In only 36.2% of fund-years did international mutual funds outperform their benchmarks after expenses and adjusting for risk using this procedure.

These results can be difficult for investors to accept. For many, the idea that buying a more costly product does not guarantee a better outcome flies in the face of their experience in markets for more tangible products. Yet modern financial markets are very different from the markets in which most individuals have day-to-day experience. Investment managers today are trading highly standardised securities with many other skilled financial professionals from all over the world. All have a direct financial interest in exploiting any mispricing between different securities, and the cost of trading is lower than it has ever been. Consistently outperforming in such a world is extraordinarily difficult, and getting more so.<sup>41</sup>

Increased recognition of the benefits of passive investment management has driven the recent growth in index-tracking funds – both unit trusts and exchange-traded funds (ETF's) across the world. Increased use of passive investment by investors may have other benefits – in international markets, it is associated with other positive market outcomes, such as lower fees for active management and a lower prevalence of managers who pretend to be active but whose portfolios mimic their benchmarks too closely to offer any realistic chance of outperforming.

#### *Passive investment management in South Africa*

Information on the investment strategies followed by pension funds in South Africa is hard to find. Large funds may be forced to hold portfolios close to the market index. This may be the reasoning behind a “core-satellite” approach to fund management.

*Reasons why passive fund management may be underused in South Africa*

In South Africa, index-tracking funds do not appear to be available to retail investors on many investment platforms, particularly on the cheaper fund platforms. Furthermore, they do not appear to be popular investment products as their fund size is small relative to the unit trust or ETF universe as a whole. Fees (and fee structures) also vary quite substantially between different index tracking fund options. Despite all of these caveats, low-cost index tracking funds

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<sup>40</sup> Cremers, Martijn, Miguel Ferreira, Pedro Matos and Laura Starks, 2011, *The Mutual Fund Industry Worldwide: Explicit and Closet Indexing, Fees and Performance*. Working paper available at: <http://ssrn.com/abstract=1830207>.

<sup>41</sup> In fact, in the words of one famous academic in his 2008 Presidential Address to the American Finance Association, active investing “is a negative sum game.” Kenneth French, Presidential Address, American Finance Association, 2008.



appear to have performed quite well relative to their peers on an after-cost basis.<sup>42</sup> Yet the volumes invested in these funds appear to be quite small.

The reasons for this are not clear, but may be related to:

- Behavioural factors, most notably, the triumph of hope over experience. Few investors, wholesale or retail, may be willing to recognise their (apparent) inability to pick managers or stocks successfully, and accept index-related performance.
- Moral hazard problems caused by intermediary incentives. Partly, this may be caused by rebates paid by investment managers to intermediaries, including investment platforms, and a reluctance by active managers to undercut their own actively-managed investment funds on platforms which they control. Recommending active investment options also allows intermediaries to offer advice on manager selection as well as asset allocation, and charge consequently higher fees.
- A lack of appreciation of the cumulative nature of apparently small annual fees by investors.
- Measuring outperformance relative to inappropriate benchmarks. Investors may fail to appreciate that the out-performance reported by their investment managers is often measured relative to undemanding or entirely inappropriate self-reported benchmarks. The issue of appropriate performance benchmarks is discussed in the section on performance fees.
- A large fraction of the JSE is closely held, or otherwise infrequently traded, and there may be systematic differences between the portfolios of foreign and local investors caused by the greater off-shore diversification of foreign investors. This may cause broad cycles in the average performance of local investors relative to the All Share Index which bear little relationship to manager ability. In such a market, accurately measuring the value added by local active managers, requires a benchmark which reflects these factors.

## ■ Portfolio and manager diversification

The benefits of diversification are well appreciated by most investors. A portfolio which is diversified across imperfectly correlated asset classes and individual securities or investments within those classes has a risk-return profile which is superior to the risk-return profile of any particular individual constituent asset. CIS's exist precisely because they pass on the benefits of diversification to investors. The model is so successful that the number of collective investment vehicles far exceeds the number of

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<sup>42</sup> It is worrying, but possibly quite revealing, that the only South African index fund to have performed worst in its fund class in Profiledata reports is the fund which has the highest initial and recurring charges of all the index-tracking funds quoted there, but is also the largest in this group by assets under management.

listed securities in most developed financial markets (including South Africa).

*Why diversifying across too many active managers is a bad idea*

Diversifying across different investment managers which invest in the same underlying asset class is a very different proposition from diversifying across individual securities. In a market such as the JSE where the vast majority of investors are institutional, an investor who diversifies across all investment managers would obtain an underlying portfolio which represented the broad underlying investible market, in other words, a passive portfolio. This is because the differences between the holdings of various investment managers must – by definition – offset one another. Such an investor would be much better off in the long run investing directly in the average (passive) portfolio, and skipping the layer of active manager fees paid to the various managers. A further complication is that such managers often trade with one another, incurring costs which serve only to reduce the return enjoyed by the client.

Diversifying across different investment managers does diversify the operational risks associated with each manager, which is an important consideration. This diversification against operational risks could, of course, be obtained by diversifying across various passive investment vehicles.

Many institutional funds achieve diversification across asset managers by investing in multi-manager funds or through implemented consulting arrangements. The value proposition here lies in the claim of the multi-manager or implemented consultant to be able to identify, in advance, investment expertise in underlying managers. Multi-managers add another layer of fees and the associated conflicts of interest into the investment value chain. An investor who, with the aid of a financial advisor, chooses a multi-manager fund through an investment platform could end up paying four layers of charges, plus up to two layers of performance fees, to obtain performance before fees which is unlikely to differ greatly from that of an appropriate passive fund.

## ■ Performance fees

Around 20% of South African unit trust asset managers appear to be compensated using a combination of asset-based fees and fees based on the return of their portfolios, often in relation to the return on a chosen benchmark. These are called performance fees.<sup>43</sup> In the US, performance fees appear to be quite rare, although they are more common in Europe. Several surveys have reported a rapid growth in the prevalence of performance fees in the UK and Australia.

*Benefits of performance fees*

In principle, performance fees may be one way of aligning the incentives of fund managers and their clients, and, to the extent that active management can generate higher returns, they give managers greater incentives to seek the highest returns possible.

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<sup>43</sup> The proportion of bulk asset managers compensated under these arrangements in South Africa is unknown at this time.

Flat asset-based fees also provide strong, but implicit, incentives for managers to generate high returns, although this is only true to the extent that investors follow high returns by investing in funds which have generated them. Where investors follow high returns, funds which do well because of high performance may attract new investors, leading to greater fees. Funds which do poorly may equivalently see an outflow, leading to lower assets under management and hence lower management fees.

*Flat fees also provide managers with positive incentives*

However, performance fees may also have poor incentive effects. To the extent that managers are not able to systematically generate outperformance, performance fees reward luck rather than skill. Reliable evidence that managers can systematically out-perform is, as discussed above, scanty. Performance fees also magnify the incentives of managers to engage in what is called tournament behaviour: systematically adjusting the risk in the portfolio, depending on whether performance is ahead of or behind the benchmark, in order to maximise the value of the fees, thereby harming investors. For instance, if managers are ahead of the benchmark, they may return the portfolio to the benchmark in order to 'lock-in' outperformance, causing them to be rewarded for closet indexing. If performance is below the benchmark, they have a strong incentive to increase the divergence between the benchmark and the underlying portfolio in order to try and generate outperformance, exposing the owners of the assets to higher basis risk.

*Poor incentive effects of performance fees*

Analysis of the effects of performance fees should take into account both tournament behaviour and strategic fee-setting by asset managers: those which have outperformed in the past are more likely to choose fee structures which reward outperformance than those which do not. A recent study by Grant Thornton in the UK<sup>44</sup> concludes that performance fees have had little effect on manager performance over the period 2003 – 2007, and that their main effect appears to have been to increase financial returns to asset managers.

*Little evidence that performance fees improve performance*

Even if managers can generate outperformance, for performance-based fees to be effective, investors need to be technically skilled in order to assess their design and likely effectiveness. Many apparently subtle changes in the calculation of performance fees – the choice of the benchmark, high water-marks, rolling periods, arithmetic or geometric performance, adjustment for fund cash flows or not, subtraction or division of the fund performance by the benchmark, the treatment of fees – may have significant effects on the ultimate performance fee paid.<sup>45</sup> For performance fees to be effective, several conditions need to hold.

*Inherent complexity of performance fees*

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<sup>44</sup> Grant Thornton, *Performance fees: a question of purpose*, August 2008, [www.grant-thornton.co.uk/pdf/Performance\\_Fees\\_July\\_08.pdf](http://www.grant-thornton.co.uk/pdf/Performance_Fees_July_08.pdf)

<sup>45</sup> *The final report of the superannuation review in Australia expressed the view that few trustee boards in Australia possessed the requisite degree of skill to assess performance fees, and the situation is unlikely to be different in South Africa. The ability of retail investors to accurately assess performance fees is likely to be even lower.*

*Properties of a good benchmark*

First, the benchmark against which performance is measured needs to be chosen appropriately to ensure that only genuine outperformance is rewarded. A good benchmark:

- reflects the fundamental risk and return drivers of the underlying fund;
- is tradable (e.g. JSE ALBI rather than CPI + 2 per cent);
- is fully investible or ‘free-float’ based (e.g. JSE SWIX vs. JSE ALSI);
- includes reinvested income (total return index rather than index level);
- is gross of fees;
- is adjusted for fund cash flows;
- purges as many factors as possible that are beyond the manager’s control from the evaluation of his or her performance by reflecting as closely as possible the manager’s chosen investment style (e.g. a ‘value’ manager should be evaluated against a ‘value’ index) for the purpose of paying performance fees.

*Properties of well-constructed performance fees*

Secondly, there should be few, if any, strong kinks in the performance fee schedule, since convexities encourage excessive risk-taking, and concavities excessive caution. There should also be strict, continuous limits on the risk of the underlying portfolio to restrict managers’ responses to the perverse incentives provided by the fee schedule.

Thirdly, the performance fee should be symmetric, so that managers bear the impact of any under-performance as well as benefiting from over-performance.

Fourthly, base fees should be lower to recognise the presence of performance fees.

Fifthly, the period of performance measurement, the method of calculation of outperformance, the effects of any weighting or smoothing, and the level and calculation method of any high watermarks should be clearly disclosed and understood by trustees. Performance fees should always be calculated by comparing the manager’s net performance against the gross benchmark, since the case for active management and performance fees rest on net outperformance.

Finally, investors should fully understand the implications of the chosen design of the performance fees, giving consideration to each of the factors listed above, as well as any others which may be material.

*Few South African investors are probably able to assess the merits of performance fees*

As shown in Box 7, many South African investment managers – including some major companies – choose to be rewarded on the basis of performance fees which are measured relative to inappropriate benchmarks, and many investors appear to believe that outperformance relative to these benchmarks reflects either manager skill or manager outperformance. This suggests that few investors –

in South Africa and internationally – are able to assess the merits of performance fees.<sup>46</sup>

## ■ Smoothed bonus policies

Some South African pension funds invest in insurance policies which aim to smooth investment returns over time, called smoothed bonus or with-profit policies. These policies promise investment returns linked to a balanced portfolio over the long run, with the refinement that they under-declare investment returns in years with ‘high’ investment returns, and then over-declare returns in years with ‘low’ investment returns. The result is a (declared) policy value which increases smoothly over time rather than fluctuating with investment returns. The welfare benefits of such smoothing are, in principle, very large. However, while superficially this appears to be a simple concept, implementing it in practice is exceptionally complex.

The main problem is adverse selection. If informed investors are aware that past investment returns have been higher than the value of bonuses declared to policyholders, they will invest in the portfolio to take advantage of future over-declarations. When the portfolio is in the opposite position, a deficit, because it has over-declared bonuses relative to actual investment returns, informed investors will withdraw. In perfect capital markets with full disclosure and no transactions costs, these informed investors will play the role of arbitrageurs, and render the smoothing of returns impossible.

*Dealing with adverse selection when smoothing returns*

To deal with this difficulty, life offices are forced to impose the following restrictions on purchasers of these policies:

- The smoothed asset value is not paid to all investors; only some members of funds (those who die, are disabled, retire, resign, or, in some cases, are retrenched) receive the smoothed value; funds that terminate early usually receive the lower of the smoothed value and the actual value of the assets used to back the portfolio, through what is called a Market Value Adjustor.
- While disclosure levels differ between life offices, the funding levels of smoothed bonus portfolios are never fully disclosed at all times. Further, to prevent arbitrage, disclosure of the underlying investments may also be limited.
- If the difference between the actual and smoothed value of assets becomes too large in either direction, life offices may close existing portfolios, and start new smoothing reserves for new business. Besides restricting arbitrage opportunities, this also serves to limit the degree of cross-subsidies between different generations of policyholders.
- As a further measure to prevent arbitrage, large cashflows into or out of these portfolios may be made subject to special

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<sup>46</sup> Arguments similar to these have led to performance fees being banned in some jurisdictions, including in South Korea.

conditions, including the maintenance of separate bonus declarations and smoothing reserves.

*Instability of portfolio funding level in times of risk*

A further difficulty with smoothed bonus portfolios is that in times of very large negative investment returns, or significant cashflows out of these portfolios, the funding level of the portfolio may become unstable.<sup>47</sup> To mitigate this risk, which is created by the policy design itself, life offices almost always provide, with their own capital, a full or partial guarantee to investors in these portfolios, and charge policyholders for the use of this capital. Since these risks are unpredictable and largely un-hedge-able, capital requirements, and hence charges, for these policies are high.

*Criticism of smoothed bonus policies*

In recent years, particularly since the demise of Fedsure, in which smoothed-bonus policies played a role, they have come under criticism on the following grounds:

*Complex, non-transparent design*

- Policy designs can be extremely complex, with different types of bonuses, which may be gross or net of charges, and opaque and complex bonus declaration rules and possible management actions.

*Consequent moral hazard by providers*

- Policyholders are unable to influence asset allocation. In some circumstances, life offices may choose the asset allocation of the underlying portfolio tactically, in order to minimize the cost to them of the guarantee they provide, either by altering the underlying investment strategy or by purchasing hedges of the investment risk in the portfolio at strategic times. These actions pass a greater proportion of the cost of the guarantee on to policyholders in the form of lower long-run expected returns.

*Internal asset management*

- Asset managers are chosen by the life office, and are almost always internal. Although asset management charges appear to be reasonable, a significant portion of what is called a guarantee charge may simply represent the costs of investment management.

*Most of the costs of 'guarantees' are actually paid by policyholders in the form of lower future bonuses*

- The division of the cost of the guarantee between shareholders and policyholders is unclear. Although the guarantee charges paid to shareholders out of these policies are often significant, much, and in 'normal' times, all, of the cost of the guarantees is actually borne by policyholders in the form of lower long-term expected bonuses. Shareholder support for these policies has, in practice, been extremely limited, despite recent volatility in capital markets. Further, management actions exercised at the discretion of the life office may pass additional costs on to policyholders, particularly in times when the insurance company is under financial stress.

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<sup>47</sup> This is because the smoothed asset values are paid out of policyholder funds. Any payments of smoothed asset values out of the fund therefore cause the funding level of the portfolio to diverge from full funding in either direction. If a high guarantee value is paid to one group of policyholders, remaining policyholders are worse off, and face a promise with a consequently lower value. This is a form of risk shifting. In extremis, future generations of investors may suffer a risk of catastrophic loss.

In response to these criticisms, since 2007, life offices have been required by the FSB to publish their Principles and Practices of Financial Management, which describe their investment policy, bonus declaration policy, and how the amounts deducted from the policyholder funds will be determined. These documents are long and complex, but typically reveal little about the basis under which charges are determined. Many insurers also release further details regarding the investment strategy and performance of the underlying portfolios.

*Industry and regulator  
response to these criticisms*

Purchasers of these policies will need to be comfortable with the risks and costs – both explicit and implicit – that they, as policyholders, bear, relative to unsmoothed alternatives. Since the future performance of these policies depends on policyholder behaviour, this would include the risks caused by future cash flows into and out of the portfolios.

Yet, reflecting the inherent complexities of these products, understanding smoothed bonus portfolios is exceptionally difficult. Much of the guarantee premium, and much of the risk, is in respect of times when investment markets – and insurer cashflows – are ‘abnormal’. Accurately assessing how individual savers will be affected in these situations, taking full account of abnormal investment markets, the solvency of the insurer, cash flows into and out of the portfolio, the likely management actions taken by the insurer, and the correlations between these factors, is virtually impossible.

In principle, there is no reason why retirement funds could not elect to smooth returns within the fund, rather than purchase an insurance policy which does so outside the fund<sup>48</sup>. A 2001 amendment to the PFA requires a retirement fund that ‘smooths’ the returns allocated to member accounts to pay members their actual share of the fund’s asset value when they withdraw from the fund before retirement. This requirement is in marked contrast to smoothed bonus insurance policies, which usually pay the lesser of the actual asset value and the smoothed value.

*Consistency of smoothed  
bonus policies with the PFA*

## **Investment platforms**

One further issue of concern is the treatment of rebates of investment management fees to fund platforms. This is of particular interest to commercial umbrella funds, retirement annuity funds and non-commercial funds which invest through platforms.

Historically, investment managers and financial advisors or consultants have competed with each other over the issue of asset allocation. Advisers may have a better knowledge of the needs and preferences of end-investors, while asset managers are closer to the financial markets. Both would like to use these natural advantages to allocate assets between different investment classes, and charge

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<sup>48</sup> Individual funds, especially those related to a single employer, though, may struggle to diversify the significant cash flow risks that smoothing returns may entail.

end users for this potentially valuable service. Historically, individuals might have invested in a balanced fund with a discretionary mandate, and left much of the asset allocation decision to their investment manager. Now, many investors pay a financial advisor to allocate their funds between different managers who may have much more specialised mandates, a process greatly facilitated by the emergence of investment platforms.

*Rebates as bulk discounts*

Currently, platform providers negotiate discounts of investment management fees with investment managers as a price of listing their pooled investment funds on their platform. However, partly for administrative reasons, these discounts are not usually paid directly to members. Instead, they are paid to the platform providers, which may reduce the platform management fee that retirement funds are charged in consequence, passing part, or all, of the discount on to their members. Some platforms may also pay part of the rebate to intermediaries.<sup>49</sup>

This structure has the advantage that it is administratively easier to retain a constant investment management charge for all members of a particular fund. Doing otherwise would require separate unit classes to be created for each investor.

*Rebates as commission*

However, it is important to recognise that rebates are a form of commission, paid by investment managers to platforms in exchange for distribution and administration services. These rebates could give platform providers a substantial, and entirely hidden, incentive to list higher-cost investment options on their platforms, since only high-cost investment managers can pay substantial rebates. As such, like all intermediary charges, they may have an inappropriate influence on the selection by the platform providers of the managers to be listed. Rebates may also reduce asset managers' fees, increasing their incentives to be 'closet indexers', since only then can they afford to pay the rebates required to be listed on particular platforms. They may also result in rigidities in market pricing, and impede competition between different platforms, asset managers and intermediaries.

*Rebates paid to other intermediaries*

Some platforms may also pay rebates directly to intermediaries. Although this is required to be disclosed, it may nonetheless constitute undue influence on the advice that intermediaries give to clients.

*Complexities of layered charges*

In some cases, the layered charging structures created by investment platforms may be so complex that it becomes impossible to assess who is being paid how much and for what. As a consequence, some investors may actually pay twice or even three times for some services, for instance when investors pay a financial advisor to allocate assets between different funds, and then invest in funds of funds or balanced funds with flexible mandates, in which they are paying fund managers to do exactly the same thing.

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<sup>49</sup> There appear to be at least four different types of charging structures currently in use by investment platforms in South Africa.



Another issue worth exploring is why investment platforms charge fees based on the size of assets under management, rather than on some other measure, such as the amount of new contributions, or other transactions, which probably reflect their costs more closely.

*Platform charges as a percentage of assets or new contributions*

Further, there may be some doubt whether investment platforms are able to pass bulk discounts on to their retail investors. It is striking that, despite the purported advantages of economies of scale in administration and investment management, few platforms seem able to offer all-in charges for retail unit trusts which are lower than direct retail investment into the same unit trust. This may suggest that fund managers are concerned to ensure that distributing their products through platforms does not adversely harm their own, in-house distribution, a form of resale price maintenance.

There are several possible solutions. One option, already the case under the code of conduct applicable to investment platforms under FAIS, is that all rebates be disclosed to customers. Other options would be either to require that all rebates be paid to consumer accounts in full, or to ban rebates in their entirety by insisting on ‘clean’ unit prices for all investors. This issue will be investigated in more detail as part of the distribution review of the retail and institutional retirement markets.

*Possible regulatory options*