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RETIREMENT FUND REFORM IN SOUTH AFRICA

Coronation Fund Managers would like to commend National Treasury on a holistic, comprehensive review of retirement funding policy as set out in the discussion paper released in December 2004. We believe that this review is timely, in the best interests of the economic wellbeing of South Africa and all its people, and are therefore highly supportive of Government's broad objectives as set out in the paper.

As members of the ACI and IMASA, and active participants in the preparation of the responses of both industry associations, we broadly support the detailed recommendations contained in the industry submissions. The focus of this response is to highlight what we believe to be key issues as viewed from the perspective of a service provider to the Retirement Fund industry, and not comprehensive input on all the issues raised in the discussion paper.

Our key commentary is as follows:

- We support the introduction of the NSF, but believe that this should be introduced as a 'tax pre-paid' product that will enable competition in this area (refer page 1).
- IRF's should be allowed to pay commission (refer page 1).
- A comprehensive review of Regulation 28 is required, and a formal task team should be constituted to perform this review (refer page 2).
- A similar consultative approach should be adopted to facilitate the introduction of SRI for retirement funds, and SRI should probably not be prescribed assets in the near term (refer page 3).
- Member investment choice is justified by the fact that fund members carry investment risk in a defined contribution fund, and should therefore be allowed (refer page 5).
- While the governance structures applying to the Regulator may be strengthened, Retirement Fund regulation should not be separated from the FSB (refer page 6).
- Disclosure of <u>all</u> fees incurred by funds, as well as gifting practices between service providers and trustees must be regulated (refer page 6).

We believe that the discussion paper goes a long way to addressing many of the current dilemmas facing the retirement fund industry in South Africa. However, we do feel that further deliberations should endeavour to include all related parties, such as the regulator, service providers, retirement funds, all related industry bodies, as well as organised labour, business and civil society. The more inclusive the process, the greater the likelihood of the proposed reforms receiving broad public acceptance.

We thank you for the opportunity to respond to the discussion paper and are happy to provide further information in support of any of the aspects included in this submission should this be required.

Kind regards

Pieter Koekemoer | Kirshni Totaram

THE NSF AND INDIVIDUAL RETIREMENT FUNDS (IRF'S)

The objectives of broadening the reach of the system, and removing discrimination between occupational retirement funds and individual retirement funds cannot be faulted.

Making the system more cognisant of the current South African reality, by expressly catering for the ± 35% of the economically active population either in informal employment or in non-tax paying formal employment is an overdue reform required to create a more equitable and morally justifiable policy framework. Equal treatment of the self-employed with those in formal employment is also a logical extension of the principles embodied in our Constitution.

However, some of the proposals may be difficult to implement:

- The NSF as a single entity rather than a defined and regulated 'tax pre-paid' product is problematic. As comprehensively discussed in the various submissions made by the ACI on this topic, we believe that regulated market participants should have the ability to compete for this business. The early indications of the successful implementation of the Mzansi bank accounts by various banking institutions demonstrates that existing financial services providers can deliver value for money products to lower income earners. However, we agree that there is no reason why Government, as with the retail bond, could not provide a solution in this category. An adapted version of the retail bond, with a balloon payment at retirement, is a possible solution for paying a retention bonus for NSF monies retained until retirement. Equal access for all, subject to contribution limits (similar to the UK's ISA model), for the 'tax pre-paid' product is our preferred 'affluent abuse' limitation.

- More consideration should be given as to how NSF assets should be managed. Assuming that competition is allowed at this level, a separate investment regulation guideline may be required (see also comments under 'investment regulation' on page 2). In particular the current recommendation of a large default allocation of the fund into government bonds would need to be looked at in more detail. The aim of these funds would be to produce credible returns that at least provide a hedge against long-term inflation and remove the risk of capital loss to the members.

- We are in agreement with all points raised in respect of IRF's, except the prohibition on commission payments. Abuse could be limited through regulation, but the need to pay for distribution in some form is a feature of the individual savings market in all countries with well developed savings industries.

- Compelling employers to offer differentiated choice of membership between a standard occupational fund, an IRF or the NSF is sensible. Allowing competition in the NSF market may make this easier to implement.

- Whilst the "package" option supported by Treasury is appropriate for occupational retirement funds, IRF's should be allowed to operate on a "savings only" basis.

INVESTMENT REGULATION

We agree that implementing an appropriate investment strategy based on fund circumstances is preferable to the herd mentality created by the asset class limitations in the existing Regulation 28. However, clear and unambiguous prudential guidelines remain a necessity, especially for IRFs, umbrella funds, and smaller occupational retirement funds. We support IMASA's submission that the default option should be a bespoke investment strategy, with specific regulatory approval required for adopting the standard prudential limits envisaged in paragraph. 7.5.4. of the discussion paper.

However, the regulator must have the appropriate skills and expertise (both on the asset and liability side) to grant these special exemptions where deemed appropriate and necessary. We further support IMASA's suggestion that the prudential guidelines would need to be looked at in great detail with emphasis on different strategies for different risk profile funds especially if these guidelines can be used as a default option. Where the prudential limits apply, it is sensible to retain a consistent approach for direct investments and pooled investments through e.g. collective investments and life licenses.

Clarity is also required on how the look-through principle should apply to 'alternative' assets such as hedge funds, private equity funds, structured products and SRI. These assets should be specifically addressed in a revised Regulation 28.

We believe that the concept of introducing a defined set of benchmarks, while at the same time moving away from a standard set of prudential guidelines, is flawed. Benchmarks given to asset managers very much depend on the mandate provided by the client. It may be more appropriate to provide guidance as to what, according to the Regulator, is best practice in performance evaluation. This may assist in limiting irresponsible marketing, an undue focus on short term performance, and an over-emphasis on generic peer group evaluation of asset managers. Care should be taken that regular performance measurement of asset managers does not result in increased short term emphasis in investment decision-making which will ultimately be more costly to the fund. We do believe that the regulator has a role to play in providing guidance as to appropriate sets of assumptions used in fund valuations and the asset-liability modelling process. These have a huge implication on the eventual strategy implemented by the fund and are often more important than just focusing on appropriate monitoring of the asset manager performance.

It is important to ensure that retirement fund trustees and their investment managers exercise their voting rights as shareholders in the best interests of fund members. It should be noted however that the investment manager is often closer to the specific share-related issues, and any regulations in this regard should be drafted in a manner that would not unduly complicate the efficient execution of votes. It is proposed that fund managers apply a formal, consistent proxy voting policy (which may form part of the mandate granted by the fund to the manager), and disclose its voting history to trustees on a regular basis.

Finally, the opportunity should be used to update the existing one-dimensional Regulation 28 to cater for additional investment categories and broader strategic asset allocation ranges for different risk profiles and/or life stages.

We strongly suggest that the input of industry practitioners and the FSB be obtained through a formalised forum prior to finalisation of the position regarding investment regulation.

SOCIALLY RESPONSIBLE INVESTMENTS (SRI)

Mobilising the formal savings industry to contribute to job creation, infrastructure development, BEE funding and housing provision is desirable and forms part of the objectives of the existing Financial Sector Charter. Reducing unemployment will not only benefit the economy and enhance social stability in South Africa, but will also enhance the retirement benefits of many individuals who currently support extended families.

However, key issues surrounding SRI still need to be addressed. These include *inter alia* the definition of SRI, the benchmarking of 'developmental' SRI allocations, the appropriate prudential guidelines for SRI, and the desirability of making SRI allocations compulsory.

Definition

The definition of a socially responsible investment needs to clarified. There are 2 general streams of SRIs:

- Developmental investments
  South Africa's unique history and the legacy of apartheid has created under-serviced communities in large parts of the country. The lack of basic services such as running water, tarred roads, electrification, etc. has created a need for infrastructure development. Therefore, one form of desirable SRI will focus on the funding of infrastructure related projects.

  Clarity is required on whether investments specifically aimed at job creation, BEE funding and housing provision could be included as developmental SRI.

- Ethical investments
  This is the form of SRI as normally defined in developed countries. The focus is typically on applying ethical and moral bias such as excluding investments in alcohol, gambling, tobacco, etc. This stream of SRI also includes shareholder activism, good corporate governance and triple bottom line investing.

Benchmarking

In many instances, SRI should not be seen as a separate asset class, but rather as a subset of traditional asset classes. Thus, the benchmarking of these funds can be consistent with traditional benchmarks. For example, should a fund have a 20% allocation to bonds, 25% of this allocation (i.e. 5% of the total fund) can be allocated to socially responsible bonds. This SRI bond allocation will form part of the overall bond allocation and performance would still benchmark to the All Bond Index. Hence it may be sensible to regulate prudential limits to SRI at the asset class level.

The draft paper suggests that an SRI should maintain its real capital value (footnote 49) to be regarded as a sound investment. This seems incongruent to other asset classes. JSE-listed equities are able to drop in value, yet currently 75% of a retirement fund can be exposed to this asset class if deemed appropriate, and even an RSA government-issued bond loses capital when interest rates rise.

Portfolio construction

Infrastructure investing has proven to be less volatile but also less liquid in terms of tradability. It is clearly imprudent to introduce significant exposure to illiquid instruments as it may result in an inability to deal with client withdrawal needs. Therefore a 'development' SRI allocation should be limited, but on a look-through basis where the allocation is made to a pooled investment including SRI assets. For example, an SRI bond fund may hold a portion in RSA issued debt for liquidity purposes as well as for use in duration and yield curve matching.

If the look-through principle is not applied, the allowable level of non-infrastructure debt required for a pooled investment to be classified as SRI is contentious as it also needs to account for cash flows, availability of suitable projects etc. These issues would also need to be taken into consideration in formulating guidelines for SRI.

The 10% investment level mooted in the reform paper is problematic. We feel that given the current size, scope and liquidity of the market the level is set too high. Another issue around enforcing SRI lends itself to more debate. Currently, the Financial Sector Charter recommends voluntary SRI allocations, with the debate still open as to how the Charter guidelines will apply across unit trusts, retirement funds, life companies, etc. With the first major FSC review date set for 2008, it may be premature to require a minimum level of investment at this stage. If made compulsory, appropriate phase-in time should be allowed for funds to implement up to a prescribed minimum level.

The balancing act required is highlighted by the UK experience where an actuary can simply sign off that 'developmental' SRI are not appropriate for a fund. This would clearly be counter-intuitive to what Government is trying to achieve with this initiative.

Conclusion

While the above goals are both commendable and achievable, prudence in the implementation process is required. This is a largely untried and untested area, requiring realistic lead times to ensure appropriate investments are made. Issues of liquidity, valuation, size of investable universe, availability of securitised instruments, appropriate structures for pooled vehicles and the ability of developmental SRI to produce adequate levels of return need to be considered. Further work is required in this regard, and we therefore support IMASA's suggestion of a task team of National Treasury, the FSB and the relevant industry associations.

We do not advocate the introduction of prescribed minimum SRI allocations at present, but if adequate investments are not forthcoming on a voluntary basis, some form of regulated enforcement may eventually be required.

MEMBER INVESTMENT CHOICE

It is important to note that the principle justifying the availability of member choice is that the member carries the investment risk in a defined contribution retirement fund. It would therefore be unduly restrictive and paternalistic to prevent member choice completely. We feel strongly that member choice should be a feature of IRFs in particular and the retirement fund industry in general.

We do however acknowledge that the majority of occupational retirement fund members may prefer assistance in managing their investment risk, by giving their trustees full responsibility for setting appropriate investment strategy and implementing appropriate investment management arrangements. In addition, most existing member choice arrangements are more expensive than a single investment option, meaning that many fund members are paying for functionality they do not wish to use. Finally, it is proposed that employers be compelled to allow employees to opt out of the occupational retirement fund and invest in an IRF instead.

It is thus logical that, if member choice is offered via an IRF, it may be superfluous to also make it available via the occupational retirement fund. However, we do not entirely support IMASA's proposal of disallowing occupational retirement funds from offering member choice. We believe that it is a member's prerogative to vote their preference. In reality, the combination of the duties placed on trustees, market forces and improved member education will cause funds to move to the appropriate option over time.

The obvious advantages of IMASA's proposal is that the assumption of responsibility to discharge investment risk is an active decision, and that any cross-subsidisation of the potential higher cost of choice (by members who do not want this functionality) will be avoided.

Where member investment choice is allowed for any occupational scheme, we believe that this does not relieve trustees of their responsibilities in ensuring that all choices offered on the platform are suitable and have undergone a sufficiently rigorous process of scrutiny. Furthermore, appropriate allowance needs to be made for differing risk profiles of members during various stages of their employment.

GOVERNANCE

Powers of the Regulator

Separating the regulation of pension funds from the FSB appears counter-intuitive. In addition to the existing economies of scale benefits, we believe that the introduction of IRFs will significantly increase the activities of private sector financial service providers subject to the jurisdiction of the Pension Funds Registrar. All these service providers are also supervised by the FSB. The governance structure applicable to the Regulator, as envisaged in paragraph 1.11.1, can most likely be created without affecting the existing co-ordination between the different FSB departments.

A further issue (with regard to IRFs) that requires specific regulatory attention is ensuring a fair and efficient transfer process between different retirements funds.

Trustee conduct

We are in broad agreement with many of the issues raised in the reform document with regard to trustee conduct and fund governance issues.

We support the introduction of codes of good practice, but believe that certain aspects of governance, such as disclosure of conflicts of interests, and limits in terms of trips, gifts and other benefits that may be provided by service providers to trustees, should be regulated. In particular, the AIMR Code of Conduct addresses the issue of gifting, thus limiting the extent to which service providers or companies can influence analysts' recommendations or trading.

We are also supportive of full disclosure of all fees charged by service providers to the Board of Trustees. This should also include charges on products where the explicit fee quoted does not account for any rolled up charges. This is specifically relevant to structured products and guaranteed funds.