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Our ref: JH

Mr Jonathan Dixon
Chief Director: Financial Sector Policy
National Treasury
Private Box X115
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By e-mail: jonathan.dixon@treasury.gov.za

Dear Jonathan

LOA SUBMISSION: RETIREMENT FUND REFORM

I refer to the LOA submission on the above dated 31 March 2005.

At that time the LOA pointed out that its comments and proposals on umbrella funds required elaboration. In this regard we are attaching a supplementary submission regarding commercial umbrella funds. The findings and comments contained therein have been gathered from three of the largest commercial umbrella fund sponsors in the membership of the LOA.

Please contact me if you have any questions. We look forward to hearing from you.

Regards,

ANNA ROSENBERG
Legal Adviser





LOA SUBMISSION

RETIREMENT FUND REFORM: COMMERCIAL UMBRELLA FUNDS

1. INTRODUCTION

- 1.1 In its previous submission to National Treasury in response to the discussion paper on retirement fund reform (the Discussion Paper”), the LOA indicated (in paragraph 9) that it was aware that its proposals required elaboration. The LOA also expressed a desire to engage further with National Treasury on the issue of umbrella funds. As a supplement to its first submission, the LOA presents the following findings and comments. These have been gleaned from three of the largest commercial umbrella fund sponsors in the membership of the LOA.

2. SUMMARY OF COMMENTS/FINDINGS

- 2.1 There is a significant cost advantage for smaller employers participating in an umbrella fund rather than a stand-alone fund. “Small” in this context could be up to 1000 employees.
- 2.2 Commercial umbrella funds offer flexibility to participating employers and employees that may not be available in bargaining council funds.
- 2.3 There appears to a category or categories of enterprises for which the commercial umbrella funds is particularly suited as a retirement savings vehicle.
- 2.4 New regulation should aim at balancing improvement in governance with cost effectiveness. For instance, the cost of independent trustees forming half the management board membership, as proposed in the Discussion Paper as a condition of exemption from member-elected trustees, is likely to be a cost-effective governance measure, whereas there is a question-mark over the cost-effectiveness of the annual general meeting of umbrella fund members, also proposed in the Discussion Paper. Limitation of the member of sub-funds in an umbrella fund should be related to the administrative capacity of the fund sponsor/administrator, and not an arbitrary limit that ignores economies of scale achievable.
- 2.5 It is noted that greater detail about the information that supports these comments and findings has not been supplied by the fund sponsors because of competitive concerns. They have, however, each expressed the willingness to discuss the findings with officials of National Treasury on a confidential basis, if so desired. The LOA can supply the names of the fund sponsors concerned to National Treasury.

3. COMMENTS/FINDINGS: LARGE UMBRELLA FUND - SPONSOR A

The following are the findings and comments of a large commercial umbrella fund sponsor identified simply as ‘A’.

3.1 Comparisons of umbrella fund costs for participation vs. a stand-alone fund

3.1.1 In researching the database for of those funds administered and previously administered by A, the following information came to light in regards to the costs of stand alone-funds vs sponsored fund.

- A participating employer consisting of 100 members with assets of R 4 million in sponsored funds would pay 18.75% of the administration costs of being in a stand-alone fund.
- A participating employer consisting of 400 members with assets of R 32 million in sponsored funds would pay 37.5% of the costs of being in a stand-alone fund.
- A participating employer consisting of 1 000 members with assets of R 150 million in sponsored funds would pay 88% of the costs of being in a stand-alone fund

These costs exclude the audit fees, which each stand-alone fund incurs in full but is included in the costs of the sponsored umbrella funds.

3.1.2 In addition to the above A compared the percentage reduction in investment yield as a result of administration, investment, distribution and Retirement Fund Tax for different sized stand alone-funds and compared this to the reduction in yield of these costs in a sponsored fund.

- The reduction in yield for the sponsored fund for 100 members and R 5 million in assets was 2.91%. The greater the membership and assets the lower this gets.
- The reduction in yield for a stand-alone fund of 100 members and R 5 million in assets was 4.97%
- The reduction in yield for a stand-alone fund of 1 000 members and R 75 million in assets was 2.35%
- The reduction in yield for a stand-alone fund of 5 000 members and R 500 million in assets was 1.78%

This highlights the cost benefits for funds of under a 1 000 members in being in an umbrella arrangement, as the opportunity to share costs among a greater number of participants allows for economies of scale to be achieved and effectively allows for more of the contributions to go towards retirement funding.

- 3.1.3 When comparing sponsored umbrella funds to Union umbrella funds, the costs per members of administration fees was better for participating employers with 40 or less members, but worse for those with greater than 40, as reflected in the table below:

| Nature of Fund | Sponsored Umbrella DC Funds | Union sponsored Umbrella DC Funds |
|-----------------------------------|---|-----------------------------------|
| Number of members | 165,783 | 78,935 |
| Number of participating employers | 3,387 | 840 |
| Smallest number of members per ER | 1 | 30 |
| Largest number of members per ER | 2,000 | 18,000 |
| Average cost PMPM 0-20 members | 44.21 | 15.79 |
| Average cost PMPM 20-40 members | 20.07 | 15.79 |
| Average cost PMPM 40-100 members | 15.67 | 15.79 |
| Average cost PMPM 100-500 members | 10.78 | 15.79 |
| Average cost PMPM >500 members | 8.94 | 15.79 |
| Charge Basis | % of contribution, includes any commision | Fee pmpm |

One must however consider that the member would also then be paying subscriptions to the Union each month and the flexibility offered in terms of risk and other benefits is far greater in the sponsored arrangements than in the Union.

A also found that the cost of risk benefits in the Union funds was substantially higher (sometimes double) those of the sponsored funds. A also found that the returns to members in the sponsored fund were superior to that of the Union funds over a similar period of time.

- 3.2 The target market and appropriateness of the commercial umbrella fund (rather than a stand-alone fund or a bargaining council fund for instance).

The sponsored funds typically attract small employers in the SME arena, which are not normally covered by bargaining council and Union funds. The majority of the participating employers in the sponsored funds have less than 250 members, with 80% of the participating employers having fewer than 50 members. The average annual salary of the members is in the region of R45 000 to R70 000.

These funds are attracted to a sponsored arrangement as they allow for some flexibility in the benefit arrangements offered, and assist the SME in ensuring relatively straightforward and simple administration practices.

These participating employers do not have bargaining agreements and the majority have no Union involvement at all, yet wish to provide some form of retirement and risk benefits to members. This is where the sponsored umbrella funds meet the market need by providing cost effective retirement and risk arrangements in the umbrella. These employers would not be able to afford stand-alone arrangements and do not wish to spend the time in managing these arrangements, as they are usually very focused on the day to day operations of their business.

4. COMMENTS / FINDINGS: LARGE UMBRELLA FUND - SPONSOR B

The following are the findings and comments of a large commercial umbrella fund sponsor identified simply as 'B'

4.1 Cost Comparisons

B put together a spreadsheet based on typical funds of various sizes to illustrate the costs of umbrella fund participation v stand-alone. The figures are reflective of B's current costing structure. The first column shows the number of members and the second, the ratio of stand-alone costs to umbrella fund participation costs which have been expressed as a cost per member. It makes out a very strong case for umbrella fund membership for the smaller employer.

| | |
|-----|------|
| 10 | 363% |
| 20 | 294% |
| 30 | 254% |
| 40 | 228% |
| 50 | 209% |
| 60 | 195% |
| 70 | 169% |
| 80 | 176% |
| 90 | 169% |
| 100 | 163% |
| 150 | 144% |
| 200 | 134% |
| 250 | 128% |
| 300 | 123% |

4.2 The target market and appropriateness of the commercial umbrella fund (rather than a stand-alone fund or a bargaining council fund for instance).

- 4.2.1 Bargaining council funds usually have quite rigid benefit structures. Commercial umbrellas can offer a fair amount of tailor making for each participating employer, whilst of course stand-alone funds offer the highest degree of flexible tailor making.
- 4.2.2 Cross subsidisation amongst employers is a prominent feature of bargaining council funds. This is an advantage for small workforces who hang on the coat-tails of the larger workforces. It would probably be more cost effective for the larger participations to have a stand-alone fund.
- 4.2.3 Individual employers have very little say in Bargaining Council fund benefit structures, being represented by Employer Associations. Small employers are very vulnerable in the Bargaining Council funds, especially where contribution levels are being increased and they have to go along.
- 4.2.4 The main strength of most commercial umbrella funds is that they have developed into a comparatively simple way for the average small business to offer meaningful and attractive packages of employee benefits given the highly regulated environment.

4.3 Governance Cost

The over-riding aim of any reform of umbrella fund governance must be to avoid adding another layer of cost without adding anything significant to the level of protection offered to umbrella fund members.

The following comments are made against the background of a large existing umbrella fund:

- 4.3.1 Some of the Discussion Paper proposals could raise the barriers to new entrants who wish to establish umbrella fund administration operations.
- 4.3.2 The following are potentially large expenses that could arise for an umbrella fund from the Discussion Paper proposals: the AGM for members, the member election requirement and annual financials for each participation group (sub-fund).
- 4.3.3 B expects that most umbrella funds would go for the independent trustee approach rather than member elections and estimates that the fees paid to the independents would be fairly small in relation to overall expenses.
- 4.3.4 The requirement for individual participation fund financials is probably just a simple extension of the work that currently audit-exempt umbrella funds and their administrators will have to put in anyway to give effect to the withdrawal of audit exemption, so the costs here are probably not that large.
- 4.3.5 So left as a potentially large expense arising from the Discussion Paper proposals (after removing member elections in favour of independent trustees and after accepting the annual financials for each participation group as a given) is the AGM.

Several sessions would have to be held countrywide, implying expense in notification, printing agendas and minutes and communicating thereafter. B finds it difficult to estimate the cost but conjectures that R500 000 could cover that cost for B's umbrella fund.

5. COMMENTS / FINDINGS: LARGE UMBRELLA FUND - SPONSOR C

The following are the findings and comments of a large commercial umbrella fund sponsor identified simply as 'C'.

5.1 Relative costs of umbrella fund vs. stand-alone fund participation

5.1.1 Why umbrella funds?

The main raison d'être for umbrella funds rather than stand-alone funds is cost savings. Every Rand that goes to costs means a Rand less for retirement, so cost containment is vital for healthy retirement provision.

5.1.2 Costs

Many costs of a fund are largely independent of the size of a fund (e.g. registration of rules), it is therefore advantageous, from a cost point of view, to have members grouped in the largest possible funds. These fixed costs mean that funds below a certain size are not viable because costs of services consume an inordinate percentage of contributions. A way of overcoming this problem is the use of umbrella funds.

5.1.3 Various types of umbrella funds

Umbrella funds come in many forms and their efficiency in reducing costs vary accordingly. Umbrella funds range from those offering minimum options to participating employers, which provide maximum cost savings, to those allowing a multitude of special rules and options to participating employers and members, here cost savings are generally less. For a small employer participating in a large straightforward umbrella fund, costs can be of the order of 20% of the costs that would have been incurred if it were a stand-alone fund i.e. an 80% cost saving can be achieved. In a highly sophisticated umbrella fund with many options, the cost saving can be of the order of 20%.

5.1.4 Size

The efficiency of umbrella funds in reducing costs also depends on the umbrella funds attracting a sufficient number of participating employers/members to generate the benefits of scale. Obviously the number of employers/members should never exceed the number that the umbrella fund administrator can administer properly.

5.1.5 Trustees

Umbrella funds also contribute to reducing overall costs to employers of providing retirement benefits in that they can reduce the amount of time that management and employees have to spend on trustee duties. Trustee duties are increasingly onerous and

involved. Small employers do not have specialist human resources departments that can supply suitable employer trustees. Small companies can also be adversely affected by the loss of productivity resulting from several employees having to act as trustees. It would be to the benefit of these companies and their employees if the trustee duties could be performed by a board consisting of at least 50% independent trustees. There can be no doubt that umbrella funds enable many small employers, who would not otherwise be able to do so, to provide retirement benefits for their employees.

6. CONCLUSION

The comments and findings cited above reinforce the points made in the first submission by the LOA to National Treasury on umbrella funds. Umbrella funds appear to be successfully meeting a need in the marketplace for retirement savings vehicle for employees of small to medium sized employers. Proposals on regulation and governance of umbrella funds should be designed carefully to reinforce rather than undermine the success of such funds.

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