



LOA SUBMISSION

RETIREMENT FUND REFORM: COMMERCIAL UMBRELLA FUNDS

1. INTRODUCTION

- 1.1 In December 2004 the National Treasury of RSA circulated a discussion paper on retirement fund reform (“the Discussion Paper”). This was to serve as a stimulus to discussion on reform of the retirement savings regime, particularly in NEDLAC.
- 1.2 As stated in the cover letter, the LOA as a member of BUSA has participated in the development of a submission by BUSA on the Discussion Paper, which the LOA fully supports, but has resolved to make its own submission to National Treasury on particular issues of concern to it. One of these issues is umbrella funds.

2. BACKGROUND TO UMBRELLA FUNDS

- 2.1 An umbrella fund may be defined as a retirement fund with members employed by several participating employers who do not form a group of holding company and subsidiary companies¹. This is a narrow definition (endorsed by reference in the Pension Funds Act, 1956) and for our purposes an umbrella fund would be one not confined to associated companies¹ either. This paper excludes preservation funds and retirement annuity funds from consideration under that term.
- 2.2 Umbrella funds so defined are found as bargaining council funds, funds for franchise holders of certain commercial groups, and as commercial funds sponsored by insurers, fund administrators and intermediaries.
- 2.3 The only regulations dealing with umbrella funds in the Pension Funds Act are contained in section 7B and regulation 30(2)(t). Section 7B allows the registrar to exempt an umbrella fund from the requirement to permit members to elect at least half the persons on the umbrella fund’s management board. Criteria for exemption are set out in circular number PF96 issued by the Registrar. Regulation 30(2)(t) merely requires umbrella fund rules to specify employer

¹ As defined in the Companies Act, 1973 or schedules thereto



participation so as to enable differentiation between umbrella funds (narrowly defined) and others.

- 2.4 Officials of the Financial Services Board have been engaged in drafting and discussing with industry representatives revisions to the regulation of umbrella funds for some time (see draft document titled “Supervision of Umbrella Funds” dated 10.09.2004). These have not yet found expression in draft legislation before Parliament. It is clear, however, that these have influenced the proposals in the Discussion Paper.
- 2.5 There has also been negative criticism of umbrella funds in recent months, largely related to perceptions that costs are excessive and governance is poor. The general perception created is negative although examples to support this criticism are not the norm (see paragraph 5 below).

3. DISCUSSION PAPER PROPOSALS

- 3.1 The Discussion Paper proposals on umbrella funds are essentially part of the proposals on regulation, governance and trustee conduct. Although there are specific recommendations related to umbrella funds, the more general recommendations on governance impact on these funds as well. In dealing with the principles of retirement reform, the Discussion Paper states that “(t)he new Act must give special attention to umbrella funds and the accompanying difficulties attached to the management of those funds” (P8).
- 3.2 The Discussion Paper proposals are set out in full below (Annexure 4 Section 5.6):
- 5.6. *The National Treasury Task Team recommends that –*
- 5.6.1. *every fund be required to have a board of trustees;*
- 5.6.2. *members of funds be given the right to elect at least 50% of the members of the fund’s board of trustees, unless the fund is exempted from this requirement for reasons which the Registrar considers in the best interests of members;*
- 5.6.3. *any fund which, with the permission of the regulator, does not grant to its members the right to elect at least 50% of the board of trustees, must have independent trustees approved by the Registrar as “fit and proper” comprising 50% of the board and 50% of any quorum required for trustee decision-making. These trustees, if paid, must be paid for their services by the funds alone and must have no financial interest or employment relationship with the fund sponsors or participating employers. They must be given special “whistle-blowing” obligations and protection from victimisation when they fulfil those obligations;*
- 5.6.4. *the statute state that trustees of funds owe a fiduciary duty to their funds and a duty of good faith to all stakeholders;*
- 5.6.5. *there be a codification of the main common law duties of trustees, including the duty to protect the rights of members in relation to benefits arising as a result of past service and the duty to disclose to members such information as they may reasonably require to make appropriate choices and to protect their rights;*
- 5.6.6. *trustees may not amend the rules of a fund in such a way as to reduce the current capital value of members’ unconditionally accrued retirement savings attributable to service to date, unless this would be necessary to ensure that the fund remains financially sound and a majority of the members of the fund have indicated in writing that they would prefer the reduction in their benefits to the liquidation of the fund;*



- 5.6.7. trustees may not seek to advance the interests of one group of stakeholders at the expense of another without their written agreement. If an employer and its employees agree on a rule amendment, the trustees should enact it provided that it is not inconsistent with compliance with any law;
- 5.6.8. trustees are obliged to take such steps as may reasonably be required to avoid conflicts between their personal interests and their duties to their funds including –
- 5.6.8.1. declaring in writing their interests in any decision in which they may have a direct or indirect personal interest – other than their interest as a member of the fund; and
- 5.6.8.2. refraining from participating in any such decision; unless this would be impracticable because their interest is as members of the fund;
- 5.6.9. the standard by which trustee conduct (including trustee decisions) is to be judged is the standard of a person who is familiar with the issues under consideration by the trustees;
- 5.6.10. trustees who lack appropriate expertise must undergo training at the expense of their funds to obtain such expertise or seek the advice of appropriate experts;
- 5.6.11. each actual or intended provider of a service or product to a fund and each representative of such provider will be obliged to disclose any interest in any service or product which is being promoted to the fund, and to refrain from taking any part in any decision by the fund in relation to itself;
- 5.6.12. providers of services to funds are required to set out in writing to the funds their advice on material matters and the reasons for their advice;
- 5.6.13. any provider of a product or service to a fund to whom discretionary power is granted by a fund or who has the power to make or influence a decision of a fund, must act in the best interests of the fund;
- 5.6.14. each provider of a product or service –
- 5.6.14.1. must be prohibited from accepting any remuneration or other reward from any person other than the fund as a consequence of the purchase by the fund of a product or service from that person or any person related to it; or alternatively
- 5.6.14.2. must disclose in writing the estimated or actual rand value of each actual or potential reward that they or their employer will enjoy as a consequence of the purchase of a product or service by the fund on the advice of the provider, and why he or she believes that the reward is appropriate when regard is had to the value of the provider's advice;
- 5.6.15. each service or product provider which is requested to provide a quotation in respect of services or products must, if it proposes to pay any commission or other reward to any person as a reward for facilitating the purchase by the fund of the product or service, disclose the rand value of that commission or other reward and the price at which the service or product would be sold to the fund if no commission or other reward were to be paid;
- 5.6.16. the regulator has the power -
- 5.6.16.1. after consulting interested parties, to formulate codes of good practice for trustees, including codes relating to the assessment of the performance of the trustees;
- 5.6.16.2. after due process, to fine, suspend or disqualify and, pending the appointment or election of a replacement, replace a trustee who does not fulfil his or her duties to the fund or comply with such codes of good practice as have been given statutory force;
- 5.6.16.3. after due process, to fine, suspend and/or withdraw the license of any service or product provider who or which does not comply with his or her or its obligations in the statute;
- 5.6.16.4. to determine guidelines as to the amount of fidelity cover which it would be appropriate for a fund to maintain;
- 5.6.17. trustees must –
- 5.6.17.1. be given reasonable paid time off work to attend to trustee work, including trustee training;
- 5.6.17.2. not be victimised by employers if they take decisions which are not in their employers' best interests; and
- 5.6.17.3. hold annual general meetings of the members of their funds unless exempted from this requirement by the regulator for reasons which the regulator regards as sufficient;
- 5.6.18. that trustees **may** be paid for their services but only by their funds and they may not accept substantial gifts or rewards of any kind from any persons or bodies other than their funds which relate to their occupation of the post of trustee;



- 5.6.19. *the rules of a fund must specify the maximum proportions in which contributions made to a fund will be allocated to retirement funding, administration and investment costs and risk benefit costs including risk benefit premiums;*
- 5.6.20. *umbrella or multi-employer funds should be subject to specific provisions including –*
- 5.6.20.1. *a requirement that the fund’s auditor report annually on the adequacy of systems and controls employed by the fund;*
- 5.6.20.2. *a limit on the number of fund which can form part of one umbrella fund;*
- 5.6.20.3. *a requirement that there be separate annual financial statements for each sub-fund and a prohibition on cross-subsidisation between subfunds;*
- 5.6.20.4. *a requirement that the fund’s administrator maintain adequate fidelity cover;*
- 5.6.20.5. *a requirement that an independent person report annually on the adequacy of the fund’s communication with its members;*
- 5.6.20.6. *a provision stating that any fund rule which purports to make use of a specified service provider compulsory, be of no force or effect;*
- 5.6.21. *retirement funds, membership of which is by individual choice, must –*
- 5.6.21.1. *give members a “cooling off” period after joining during which they may elect to withdraw their membership without charge (and with full refund of any moneys paid to the fund); and*
- 5.6.21.2. *permit members to have their retirement savings transferred to other funds of their choice without financial penalty and after disclosure of the costs of such transfer – which may be limited by legislation.*

4. THE NEED ADDRESSED

- 4.1 The commercial umbrella fund has a solid history of serving the need for a retirement savings vehicle for employees of small to medium enterprises who are not associated by individual or geographic sectors nor by any other forms of interest.
- 4.2 The advantages are in economies of scale. Administration costs are lower than if each employer were to establish its own occupational fund and risk benefit costs may be lower too. In particular, the regulatory costs involved in maintaining a small occupational fund would be prohibitive. A paper by Rusconi concluded that there was clear evidence of a relationship between fund size and administration costs, where the larger the fund, the lower the costs per member. The paper suggested that this supported moves towards umbrella arrangements, although the paper did not have statistics on those.²
- 4.3 Further, a perceived advantage for employers, and one marketed by certain sponsors of umbrella funds, is in the application of the exemption from member-elected trustees. This removes this element of fund management and cost from the employer’s workplace. Generally small and medium enterprises have neither the skill nor resources to undertake the onerous responsibilities of a board of trustees.

² Costs of Savings for Retirement. Paper presented by Rob Rusconi at the 2004 Convention of the Actuarial Society of South Africa. P83



5. THE PROBLEMS

5.1 In public discussion of commercial umbrella funds, two issues in particular have drawn negative attention:

5.1.1 The possible exemption of such funds from the requirement to enable members to elect trustees³.

5.1.2 The locking in of such funds to services provided by or under the auspices of the sponsor. The presumption behind this is that the resultant lack of potential competition with other service providers leads to excessive costs. These in turn (in a defined contribution environment) eat into the retirement savings of the member⁴.

5.2 Another point of criticism is that employers make decisions on entry to and exit from the umbrella fund. The board of trustees has no member representation. The board, further, is often dominated by appointees of the sponsor. Among these will be one or more trustees who are not employees of the sponsor, administrator or other service providers; but may, nonetheless, be paid by the sponsor for trustee work (in some cases the trustees are paid by the umbrella fund). There is clearly potential for conflicts of interest among the fund trustees.⁵

5.3 Against this must be placed the following considerations:

5.3.1 The absence of common interests between the various employers and groups of employees makes “representation” by elected trustees problematic.

5.3.2 Trustees are not in any event representative of electoral constituencies. Their fiduciary duties are onerous, and they must demonstrate independence, knowledge and ability, whatever the source of their election or appointment.

5.3.3 Management of large umbrella funds requires considerable experience and expertise, which may not be available among the membership or among the candidates for trustees that members might propose.

5.3.4 Cost competition is potentially provided by the number of umbrella funds already in existence, and the ability of employers to move between them.

5.3.5 Sponsors go to considerable expense, in many cases, to set up the product and administration infrastructure of umbrella funds. The sponsor markets the fund and provides the strength of

³ The presentation by COSATU at the NEDLAC Trustee Conference (29-30 October 2004) and the PCOF hearings on the Discussion Paper (15-16 February 2005), for instance.

⁴ Article by Bruce Cameron in Personal Finance dated 3 July 2004 for instance.

⁵ See for instance a Paper delivered to the Pension Lawyers Association of South Africa in 2004 by Jonathan Mort.



brand and reputation to back the fund. Removal of services from the sponsor could lead to considerable loss to the sponsor, and consequent removal of support to the fund.

5.4 A successful umbrella fund regime would appear to require a balancing of the interests of the sponsor and the interests of the other stakeholders so that

5.4.1 The sponsor supports the fund

5.4.2 Members are protected by sound administration, charges commensurate with benefits, information to make decisions about benefits and, as a last resort, power to move to another fund or provider without severe loss.

6. STATISTICS

Below are some approximate (consolidated) statistics from 3 of the LOA's largest member offices. We were not able to gather more comprehensive or representative data in the time available.

Company A:

No of commercial umbrella funds	11
No of members per fund	187 835
No of participating employers per fund	6116
Smallest no of members per participating employer	1
Largest no of members per participating employer	17523

Company B:

No of commercial umbrella funds	2
No of members per fund	10 000
No of participating employers per fund	70
Smallest no of members per participating employer	40
Largest no of members per participating employer	1 500

Company C:

No of commercial umbrella funds	2
No of members per fund	165 783
No of participating employers per fund	3 387
Smallest no of members per participating employer	1
Largest no of members per participating employer	1 000



7. PROPOSALS FOR A SOLUTION

7.1 There appear to be two routes available for commercial umbrella funds, depending on whether the offering is essentially to the individual member or to the employer and those members in the employer's service. The first route would be the individual retirement fund route, addressed broadly in Annexure 2 Section 4 of the Discussion Paper.

7.1.1 The LOA proposes that this broadly follows the lines of regulation of collective investment schemes with:

7.1.1.1 A corporate trustee overseeing the product offering

7.1.1.2 A rigorous disclosure regime required of the product sponsor

7.1.1.3 The freedom of investors to move easily between product offerings of different sponsors

7.1.2 This structure should be able to be offered to groups of participants, including groups defined by employment with an employer, on condition that a member committee is established in respect of the group. This committee must

7.1.2.1 Act as the channel of communication between the product sponsor and the members of the group.

7.1.2.2 Review annually the participation in the product by the employer and his employees, on the basis of required disclosures by the sponsor to the committee.

7.1.2.3 Have the right to move the group out of the product without penalty (but subject to protection of investment managers against market fluctuations).

7.1.3 The product type must be subject to access limitations so that it represents a retirement product (similar to the 401(k) product offering in the United States). This regulatory route would not require the establishment of a retirement fund with a board of trustees.

7.1.4 To preserve the essentially individual nature of the product offering, individual members of participating groups may have to be given the power to move out of the groups. This will, however, have the consequence that the benefits of group participation are unlikely to include group risk cover.



7.2 The following is proposed by the LOA as an alternative framework for regulating commercial umbrella funds with employer groups as participants using a retirement fund as the regulatory framework:

7.2.1 Trustees- At least half the trustee board must consist of independent trustees-

7.2.1.1 not employed by sponsor or service provider to the fund or a subsidiary of these

7.2.1.2 paid by the fund for trustee work

7.2.1.3 whose names appear on a list of fit and proper trustees maintained by the Registrar. The other trustees may be appointed by the sponsor and must be fit and proper persons.

7.2.2. Governance documents- The trustee board must operate in accordance with a set of governance documents including at least the following:

7.2.2.1 An acceptance of trust, detailing duties and responsibilities of a trustee in general

7.2.2.2 A code of good conduct related to the fund in particular

7.2.2.3 Mandates of subcommittees of the trustee board

7.2.2.4 Role of the chairperson

7.2.2.5 A fund positioning statement, which deals with purpose, management, role of sponsor and defining characteristics of the fund

7.2.2.6 Management process document, incorporating fund risk matrix

7.2.2.7 Investment Policy Statement

7.2.3 The board of trustees must in terms of the fund governance documents:

7.2.3.1 Monitor the performance of the service provider against benchmarks that are market-related

7.2.3.2 Require regular reports from service providers on service delivery

7.2.3.3 Deal promptly with failures in service delivery.

7.2.4 The sponsor, service providers and trustee board must establish a monitoring committee in which service delivery issues are discussed and resolved. The fund must have service agreements with the service providers which incorporate inter alia:

7.2.4.1 Standards of delivery checked upon by the trustees in terms of laid down monitoring mechanisms

7.2.4.2 The operation of the monitoring committee

7.2.4.3 The right of the trustee board to replace the service provider subject to:



- 7.2.4.3.1 A reasonable process of attempted resolution of problems through the monitoring committee
- 7.2.4.3.2 A reasonable process of consultation with employers participating in the fund (or member committees if these are established in the particular fund).

7.2.5 The sponsor must have the right to withdraw its sponsorship of the fund if it has followed a reasonable process of consultation with the trustee board first. The sponsor should also arguably have the right to recover set-up costs of the fund if :

- 7.2.5.1 The termination of sponsorship does not arise from any breach of contract by the sponsor or the sponsor's service providers.
- 7.2.5.2 The set up costs and recovery conditions have been disclosed to the board, and to fund participants before they joined the fund.

These minimal requirements should be contained in regulation.

7.2.6 Annual audit of administration system:

The administrator must submit annually to the trustee board an audit report on its systems used to administer the umbrella fund. This should specifically cover whether the size of the fund compromises the adequacy of the administrative systems supporting the fund. There should be no regulated limit to the number of participating employers or members in umbrella funds [this proposal in the Discussion Document strikes at the root of the cost effectiveness of umbrella funds, and fund sponsors could effectively circumvent this proposal by just establishing multiple umbrella funds run in very similar ways]. Limits should be applied by the fund trustees where such audit report indicates that the administrative system cannot support growth beyond a certain size.

7.2.7 Disclosure to members:

- 7.2.7.1 On joining the fund:
 - 7.2.7.1.1 Summary of fund rules
 - 7.2.7.1.2 Contributions to be made by and on behalf of the member
 - 7.2.7.1.3 Costs to be deducted from contributions (and individual account, if applicable)
 - 7.2.7.1.4 Benefit contingencies and amounts payable
 - 7.2.7.1.5 Investment portfolio(s) in which member's contributions are invested



7.2.7.1.6 If there is a member committee (to be) set up, description of the operation, rights and obligations of that committee.

7.2.7.2 Annually

- Amendments to fund rules in past year
- The same information as supplied on joining (updated)
- Value of member's accumulation
- Performance of investment portfolios.

7.2.8 Umbrella fund comparisons- it is proposed that the sponsors of umbrella funds should engage in discussion with the objective of setting up an independent survey of umbrella funds. There are difficult issues related to such a survey: including variations in benefit offerings, variations in investment offering, and consequent difficulties in comparing costs.

8. OTHER RECOMMENDATIONS IN THE DISCUSSION DOCUMENT

- 8.1 We briefly comment below on certain of the other recommendations in the Discussion Document quoted above, as they pertain to commercial umbrella funds.
- 8.2 We do not support the proposal that trustees be obliged to hold annual general meetings of fund members. The size and geographic dispersal of umbrella funds represent a problem. The goal of communication and opportunity to present members' views to trustees can be better achieved by other means, such as news letters, establishment of member committees, internet communication sites, etc.
- 8.3 We support separate financial statements per participating employer. *The financial reporting requirements must not, however, be so onerous that a large part of the financial benefit of belonging to an umbrella fund is destroyed. Our suggestion is that a single page income statement and single page balance sheet be set as the requirements.*
- 8.4 The proposed prohibition on cross-subsidisation should not extend to risk benefit and service costs, since the spreading of these is among the advantages to members of umbrella funds.
- 8.5 We have reservations about the recommendation (par.7.6.5 page 66) that only a limited number of investment options be allowed to members in funds which offer investment choice. Reducing existing ranges of choice open to and used by members will be a difficult task and an invidious one for trustees to undertake.



9. **FURTHER DELIBERATION**

The LOA is well aware that the proposals presented here require elaboration and further discussion. The LOA would welcome the opportunity to engage further with National Treasury on this issue.

Contact:
Ms Anna Rosenberg
Legal Adviser
The Life Offices' Association of SA
Tel: (021) 421 2586
Fax:: (021) 421 2599
E-mail: anna@loa.co.za