Charges in South African Retirement Funds

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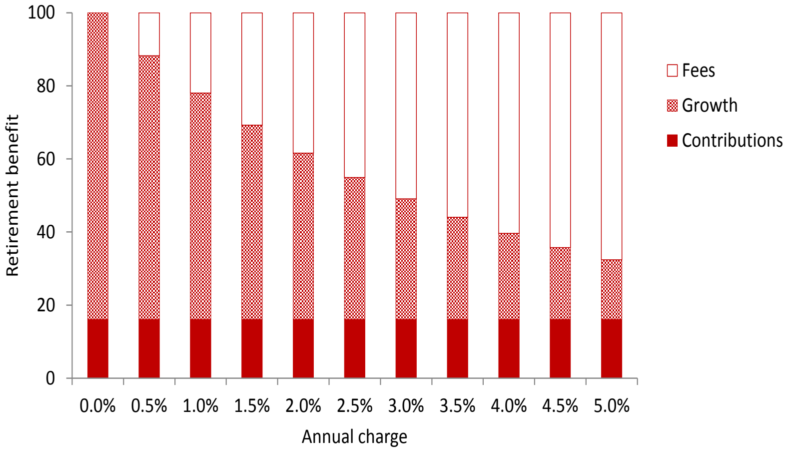
Background to Charges in SA Retirement Funds Paper

- Charges paper is the fifth and last in a series of discussion papers to promote household saving and reform the retirement industry
- Overview papers from 2012 and 2012 Budget announcements
  - *Strengthening Retirement Savings: An overview* (14 May 2012)
  - *2013 Retirement Reform Proposals for further consultation* (27 Feb 2012)
- Four other discussion papers published during 2012, for public comment:
  - *Enabling a better income in retirement* (B) (21 Sept 2012)
  - *Preservation, Portability and uniform access to retirement savings (C*) (21 Sept 2012)
  - *Incentivising non-retirement savings (D*) (4 Oct 2012)
  - *Improving tax incentives for retirement savings* (E) (4 Oct 2012)
- Charges in SA Retirement Funds (A) provides an overview of the current level of charges during the accumulation phase (i.e. before retirement)
- Note 2013 TLAB released 3 July 2012 begins to legislate some reforms
  - Uniform contributions and annuitisation of provident funds

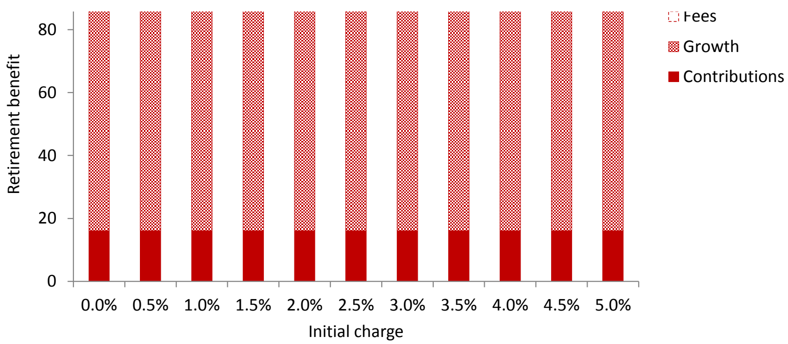
Charges are a crucial determinant of retirement outcomes

- Charges significantly reduce benefits to members, and could reduce retirement income by more than 50%

- If you can reduce your charges from 3.5% p.a. to 0.5% p.a. you can get the same benefit with contributions that are around half as large



- Initial charges are far less significant for long-term savers than recurring charges

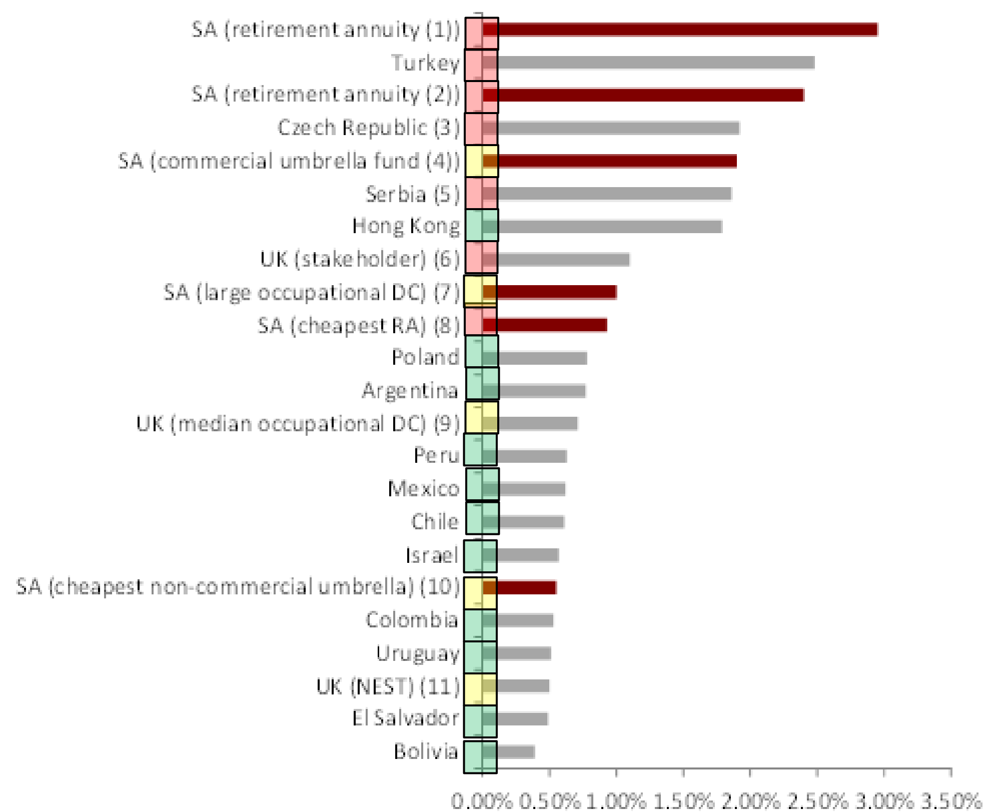


Charges and Costs

- Need to differentiate between *costs* of running retirement funds, and the *charges* that are imposed on members to pay these costs
  - Retirement funds pay costs (e.g. lawyers, auditors, asset custodians, transition managers), but members (or their employers) pay charges out of their contributions or assets
- Fund costs make charges necessary, but the relationship can be quite complex, especially in commercially-run funds such as umbrella funds or retirement annuity funds
- High fixed costs of a retirement system mean that economies of scale (in assets and members) are significant
  - So structural factors like high unemployment, lack of compulsion, low rates of preservation and fragmentation of funds lead to higher level of costs
- Key issue driving costs in a voluntary system is distribution of funds (workplace distribution is most efficient, SA has a mixed model)

SA retirement system seems expensive

- The SA retirement system appears expensive, especially given its relative maturity, and the depth and level of development of our capital markets, but comparisons are difficult for many reasons
- With some exceptions, SA relies almost entirely on market mechanisms to determine type and level of charges
- (Level of charges in DC retirement systems is an international concern)



Important factors:

- Voluntary system
- Too many funds
- Low rate of preservation
- Poor governance

Complexity may be an unintended outcome of market structure

- Few market forces operate against product & charge complexity.
- Because our retirement system is voluntary, intermediaries play a crucial role in distributing retirement savings products to customers. Yet intermediary remuneration may introduce conflicts of interest between them, product providers and customers, increasing the complexity of products and raising charges.
- As a result, commercial products can be exceptionally complex, making product comparisons difficult

- (Preference for active investment management raises charges above the lowest attainable levels)
- (Weaknesses in governance need to be addressed)
- (Funds distributed through the workplace have lower cost)

Charge shifting (usually against the interests of customers)

- As in all financial products, there are significant asymmetries of information between providers, intermediaries, and customers
- Furthermore, disclosure of charge levels to members (and regulators) is low, and customers, for various reasons, may not be especially sensitive to the level of charges, especially recurring charges. This may cause charge-shifting.
  - Shifting between initial and recurring charges
  - Shifting between types of charges (rebates disguise administration fees and sales commissions as asset management fees; performance fees off artificially low bases disguise asset management fees as performance fees; guarantee charges; early surrender penalties as ‘loyalty bonuses’)

Draft Proposals I: Consolidation, governance, regulation

- Many existing funds don't have the necessary scale, so fund consolidation is encouraged
- Governance needs to be improved (process already underway in 2013 FSGLAB)
  - Expert and/or independent trustees on all boards (KING)
  - Strengthening of governance of multi-employer funds
    - Employer and member-appointed trustees on all boards
    - Formalised role, rights and obligations of employer-level committees
- Strong regulator essential (new regulator takes office 1st August 2013)
  - Powers to monitor all aspects of system, including costs
  - Power to intervene where necessary
- Regulator may issue standardised fund rules and other documents, including SLA's, investment manager mandates, pension increase policies, governance

Draft Proposals II: Simplification of retirement savings products

- Standardise permitted charge structures of all tax-qualified products
  - For instance, providers could be allowed to levy charges based on the amount of contributions, and the amount of assets under management
    - Loyalty bonuses, early surrender penalties, fixed charges per member per month, performance fees and other conditional charges may be prohibited
    - Published charge schedules, volume discounts may be permitted
- Greater regulation of permitted investment options in compulsory membership funds which offer investment choice, special conditions for defaults
- (The freedom of service providers to set charge *levels* will not be affected, although special conditions may apply to default options)

Draft Proposals III: Greater disclosure

- Develop a measure of retirement fund charges which is common to all types of retirement fund
  - standardised, comprehensive
  - look-through basis to include all charges in layered structures
  - needs to make some allowance for conditional charges & benefits (e.g. guarantees, performance fees if these are permitted)
- Require that this measure be reported to the Regulator, with members to be provided with absolute and relative measures of their fund's level of charges
- Require that this measure be included prominently in umbrella fund quotes (similar to the way *RiY* is quoted in insurance policies)

Draft Proposals IV: Implement auto-enrolment

- Explore requiring employers to enrol employees into retirement funds automatically
- To be effective, mandation may require:
  - An exchange or clearing house, possibly integrated with the SARS tax collection system, to allow smaller employers and employees to compare plans easily and select one for their workplace
  - Private providers, regulated under the PFA, listed on the exchange if they meet certain conditions e.g. design, scale, charges
  - Exchange could standardise administration processes, e.g. transfers between funds
  - A default fund or funds, established under the PFA, to provide a default for employers and workers who make no selection, to facilitate preservation and unclaimed benefits

Process going forward

- Consultations with key stakeholders on both the analysis and the draft proposals presented are on-going, and will continue through the formal consultation process

- There will be a formal public consultation process on the draft proposals in this paper, which will close on **30 September 2013**
- Any responses can be sent to **retirement.reform@treasury.gov.za**

- Following this, firmer policy proposals will be developed, leading to draft legislation, which will enter the Parliamentary process in 2014