**Challenges to Service Providers**

Address to the Annual Conference of the Pension Lawyers Association of South Africa

Rosemary Hunter

March 2005

## 1. Introduction

Recent public comment on the roles played by service and product providers to retirement funds have not been flattering. In a recent statement, the SA Communist Party said the following:

> "It is … deeply disturbing that only about 10% of South Africa's workforce is covered by pension and provident funds, and principally those that are unionized. This happens in a country with about 40% unemployment and with more than half of its population living in poverty. The surplus generated through these funds are literally plundered by retirement fund administrators who change exhorbitant fees for their services. These administrators live like parasites on these funds, thus reducing the pay-outs of those retired, and robbing these funds of further monies for investments into infrastructure and job creation. No wonder the capitalist class has rejected the draft declaration [prepared for the Nedlac-convened retirement funds' conference]."[1]

The Registrar of Pension Funds, too, did not pull his punches when he said in a recent article in the *FSB Bulletin* that -

> "Service providers have played a major role over the years by doing the outsourced function of the administration of funds. With time, unfortunately, they have become administrators of trustees. What is needed is a clear regulatory regime to regulate the relationships between trustees and administrators and not to rely only on the service agreement between the two parties . . . Many service providers have everything in-house –administration services, investment managers, actuarial services, insurance etc. Therefore, service providers could influence trustees to keep all business in the same house". [2]

The purpose of this paper is to consider the validity of some of the charges now being levelled at product and service providers, what may be the approach of government to them in its reform of our pensions law, and how those providers should perhaps respond to them.

## 2. The costs of retirement funding provision

2.1. In his well publicized research report "Costs of Saving for Retirement"[3] presented at

---

[1] *Umsebenzi Online* Volume 3 No. 22 of 17 November 2004. http://www.sacp.org.za/umsebenzi/online/2004/uol052.htm *Umsebenzi* is the official mouthpiece of the Communist Party of South Africa.

[2] Address by Dube Tshidi, Registrar of Pension Funds, to the NEDLAC Retirement Funds Trustees Conference and reported in the *FSB Bulletin*, Fourth Quarter, 2004.

the 2004 annual convention of the Actuarial Society of South Africa, independent actuary Rob Rusconi prefaced his analysis of the costs of retirement funding provision with specific reference to stand-alone privately administered funds by saying that his analysis was difficult to perform because –

2.1.1. not all fees and costs incurred by retirement funds are disclosed either in fund accounts or valuation reports. For example, asset managers sometimes provide their performance figures as net of fees for the purposes of fund accounts and fund administration costs borne by sponsoring employers are not always disclosed;

2.1.2. the FSB and some service providers have declined to reveal the costs, the latter alleging that it was confidential information; and

2.1.3. we do not have uniform ways of measuring costs.[4]

2.2. Nonetheless Rusconi did his best with the information available to him and reached the following conclusions:

2.2.1. the costs of saving for retirement in South Africa is relatively high when compared with international comparators[5];

2.2.2. small funds have particularly high costs when compared to larger funds;

2.2.3. trustees should gather all the information that they require to ensure that the costs incurred by their fund are reasonable. This would be assisted by -

---

[3] The document may be found at http://www.pmg.org.za/docs/2004/appendices.041110rosconi.pdf.

[4] For example, asset managements fees are usually billed as a proportion of assets under management while administration fees are usually billed as a percentage of payroll. As Bruce Cameron has said in a recent article entitled "Its time for the life industry to come clean about costs", in *Personal Finance* of 23 October 2004. -

> "Retirement fund product providers, particularly life assurers, express costs as a mishmash of fixed rand costs, as a percentage of assets, on an annual basis and upfront. In fact costs are deducted in just about every way possible."

He recommends that product providers or salespersons be required to disclose their costs, the effect of both income and capital gains tax on a "reduced yield" basis. This is the percentage of gross annual return on the investment taken up by charges annually. On this basis, Rusconi says that the costs associated with retirement funding is between 1.0 and 1.65% a year.

[5] For example, he said that the charge ratio over a 40 year term is between 17 and 27 per cent. The "charge ratio" method shows the total costs as a percentage of total contributions made to a product and the growth on these contributions. In an article entitled "Call for Uniform Method of Disclosing Costs" in *Personal Finance* on 13 November 2004, Francois Marais of the Life Offices Association is reported as saying that the charge ratio was dependant on the term of the investment and the interest rate. He said that to calculate charge ratios over a 40 year period seriously exaggerated costs and virtually no investments are held for such a long term.

2.2.3.1. clear reporting requirements set by the FSB;

2.2.3.2. industry analysis to enable trustees to measure fund expenses against appropriate benchmarks;

2.2.3.3. a requirement that asset management fees be disclosed separately from gross investment performance;

2.2.3.4. industry initiatives to increase awareness of the impact of costs and recommending minimum disclosure to members including a discussion of the impact of costs on member benefits.[6];

2.2.4. our regulators should consider the possible implications of imposing maximum charge systems on part or all of the industry; and

2.2.5. they should also assess the need for a new class of products to stimulate cost-effective retirement saving such as a national provident fund.

2.3. For me the most important challenges arising out of Rusconi's report are the following:

2.3.1. The challenge to create and sell, and make profits out of, cheaper retirement funding products in respect of which costs are properly disclosed. A couple of product providers have already entered this fray;

2.3.2. The challenge to make umbrella retirement funds more effective retirement funding vehicles while ensuring proper member representation and independence from service providers; and

2.3.3. The challenge to eliminate the payment of commissions to people who merely act as brokers to an existing fund – they should be paid broking fees by the fund itself – and to stop the practice of paying upfront commissions to people who introduce new consumers of retirement funding products to a product provider. [7]

---

[6] See p113 of the Rusconi Report.

[7] In her article "Cost cuts should start with changes in the value chain" in *Business Report* 5 January 2005, Anne Cabot-Alletzhauser has responded to the Rusconi report by saying that what is needed is an effective way to properly value and price each critical contribution to the long-term objective of members of retirement funds. This should help prevent, for example, organizations that are unable to extract sufficient profit from actuarial or consulting services alone branching out

3. **Secret profits**

3.1. Retirement funds incur more "costs" than they probably realize. These take the form of special profits drained out of them by service providers in the form of benefits they derive from the management of the affairs of the funds. In particular –

3.1.1. It is a widespread practice for insurers to pay commissions to fund consultants as a percentage of the premiums paid by those funds in respect of insurance policies in terms of which fund liabilities are underwritten. While the consultants are required to disclose those commissions, this disclosure is often does in a somewhat "minimalist" fashion and is not accompanied by an explanation of the right of fund to demand that the commission be paid to the fund itself;

3.1.2. Some fund administrators or sponsors of umbrella retirement funds or umbrella death benefit trust funds receive what are known as "rebates" from asset managers. These are commissions paid by the asset managers as a reward to the administrators or sponsors for directing business of a certain volume their way. These commissions, too, should be disclosed;

3.1.3. Some service providers also take a share of the interest that a bank pays in respect of the deposit of fund monies into an account with the bank. For example, a bank may pay the provider interest at a rate of, say, 8% and the provider will only pass on to the fund interest at the rate of, say, 5%, keeping the remaining 3% for itself. Three per cent may not sound like a lot of money but it can amount to millions of rands over time if the fund is a large one with a large amount of money flowing through its bank account; and

3.1.4. A number of sponsors of umbrella funds have entered into joint venture agreements with banks in terms of which the sponsors ensure that the umbrella funds only grants housing guarantees to those members who obtain housing finance from those banks in return for which the banks

---

into asset management because that is where the big fees are even if that is not their core business and thus their field of specialist knowledge. The trustees need to determine what total cost would be reasonable for a fund to bear for all of the various services that go into providing it with an appropriate solution and then the various parties in the value chain must determine how this total cost should be allocated amongst them.[7] The problem with this proposal is that, as she points out, it demands significantly greater interaction, co-operation and transparency from all parties in the process and this is only likely when they are related to each other and derive some benefit from the participation of each in the chain. And this contrasts markedly with what I am proposing today.

grant to the sponsors a share of the profits that they derive from the business.

3.2. To the extent that these benefits are not disclosed and agreed with the fund, they comprise "secret profits" and in law must be paid back to the fund[8] whether or not the fund could have obtained the benefit of the arrangement for itself. In *Transvaal Cold Storage v Palmer* [9] Innes CJ said:

> "The doctrine of an agent's liability to account for profits does not rest upon the fact that he has prevented the principal from earning profits; but is based upon his duty in good faith to hand over to his employer every advantage directly or indirectly connected with the agency, save and excepting the remuneration agreed upon."

3.3. If these "kick backs" have been disclosed to and agreed with the trustees, the question whether they should have been agreed may still be asked.

3.4. The *Myners Review*[10] drew the attention of the UK Government to the issue of soft commissions paid by fund managers on behalf of their institutional investors such as pension funds, to dealers and, in particular, to the fact that the fund does not get involved in negotiating the terms of those commission payments.

3.5. In its response to the *Myners Review* the UK Government said[11]-

> "Trustees, or those to whom they have delegated the task, should have a full understanding of the transaction-related costs they incur, including commissions. They should understand all the options available to them in respect of these costs and should have an active strategy – whether through direct financial incentives or otherwise – for ensuring that these costs are properly controlled without jeopardizing the fund's other objectives. Trustees should not without good reason permit soft commissions to be paid in respect of the fund's transactions".

3.6. The US Employee Retirement Income Security Act prohibits fund fiduciaries from receiving any consideration for his or her personal account from any party dealing with the fund in connection with a transaction involving the assets of the fund[12]. I think that a similar provision would be useful here. If fund advisors – or their employers - were to be remunerated only by their clients, then that remuneration could be properly controlled and advisors should not be subject to the undue

---

[8] *Regal (Hastings) Ltd v Gulliver* 1967 2 *AC* 134 at 153.

[9] 1904 *TS* 4 at 21.

[10] *Institutional Investments in the United Kingdom*: *A Review* by Paul Myners.

[11] At page 66.

[12] Section 406(b).

influence that the prospect of indirect remuneration in the form of commissions is likely to have on their advice.

3.7. A service provider which wishes to be seen to be providing only excellent, impartial and independent advice and which wishes to avoid the risk of the kind of litigation now being faced by insurers in the US will take steps to restructure the nature of its remuneration with its clients.

## 4. The Spitzer Investigation

4.1. In October 2004 the Attorney-General for the State of New York announced that he was taking legal action against the leading US insurance brokerage firm alleging that it steered unsuspecting clients to insurers with whom it had lucrative payoff agreements and that the firm solicited rigged bids for insurance contracts.[13] In particular, the civil claim alleged that –

4.1.1. Marsh Mclellan received special payments from insurance companies that were over and above normal sales commissions and which had the effect of distorting and corrupting the insurance marketplace and cheating insurance customers; and

4.1.2. Marsh Mclellan at times solicited fake bids which deceived its customers into thinking that true competition had taken place.

4.1.3. In November 2004 Spitzer leveled similar charges against Universal Life Resources and Aon Corporation.[14] [15]

---

[13] See statement issued by the Office of the New York State Attorney General Eliot Spitzer at http://www.oag.state.ny.us/press/2004/oct/oct14a_04.html.

[14] See article at http://www.badfaithinsurance.org/reference/General/0021a.htm

[15] On 28 October 2004 Alexander Forbes issued the following statement published on the *Stock Exchange News Service* (SENS):

> "There is currently a well-publicised investigation into the business activities of a number of the large US-based Global Insurance Brokers. This has expanded from an enquiry into contingent commission arrangements with insurance carriers to an active investigation of improper business practices, specifically bid-rigging. Alexander Forbes is not involved in the investigation and we have not been subpoenaed in relation to the cases being reported. It is our policy to always act in the best interests of our clients. Bid-rigging is contrary to clients' best interests and is not tolerated in our business.
>
> Contingent commission arrangements with insurers are widely recognized as long standing industry practices. In light of the recent market developments we have initiated a full review within our UK and SA insurance broking businesses to identify all arrangements that could be construed as contingent commissions. To the extent this review reveals any volume- or profit-contingent commission payments to our insurance broking businesses, we intend to discontinue these arrangements in line with other major global insurance brokers. The review is scheduled to be completed and the findings released together with the group's interim results on 15 November 2004.
>
> Alexander Forbes prides itself on its record of maintaining long-term client relationships built on trust and integrity. We will continue to always act in the best interests of our clients."

4.2. The first of the allegations concerned the payment of what are sometimes known as "overrides", that is, amounts paid in addition to ordinary commissions when the volume and profitability of business received by an insurer from a broker reached or exceeded certain levels of volume and profitability. Spitzer alleges that these overrides are seldom disclosed to the clients of the brokers. Following the start of the investigation by Spitzer, which has been followed by investigations by other Attorneys-General and industry bodies, several leading brokerages have stopped claiming contingent commissions.[16] A practice which has attracted comment in the light of these investigations[17] and of which I was previously unaware is a practice of annually rewarding brokers whose clients have a low-claims experience over the year. This practice encourages brokers to persuade their clients not to claim or to frustrate their claims in some way. This is as bad as a defendant rewarding a plaintiff's lawyer for losing the case against it !

4.3. The second of the allegations concerned "big rigging". Marsh, acting in its capacity as broker, is alleged to have sought artificially high quotes (bids) from insurance companies so that a preferred insurer would win the tender. This practice is in breach of the fiduciary duty owed in common law by the broker who is required to act in the best interests of the insured because he or she is acting as its agent.[18] In the circumstances he or she must act without regard to his or her own personal interests because otherwise he or she may be in breach of his or her statutory[19] and common law fiduciary duties to the fund.

---

[16] See Donald Pfundstein, "Transparency is insurance industry's medicine" November 2004 published by Gallagher, Callahan & Gartrell on.http://www.gcglaw.com/resources/govt/pfundstein/transparency.html.

[17] See "As Spitzer insurance investigation widens CFA calls on Congress to unleash the Federal Trade Commission, Kill deregulatory proposals", a statement by Consumer Federation of America dated 27 October 2004.

[18] *Robinson v Randfontein Estates Goldmining Co Ltd* 1021 *AD* 168 at 177.

[19] Section 2 of the Financial Institutions (Protection of Funds) Act, No. 28 of 2001 says the following:

"Duties of person dealing with funds of, and with trust property controlled by, financial institutions

(1) A director…official (or trustee), employee or agent of a financial institution (or retirement fund)…who invests…, controls, administers or alienates any funds of the financial institution or any trust property –

(a) must, with regard to such funds, observe the utmost good faith and exercise proper care and diligence;

(b) must, with regard to the trust property in the terms of the instrument or agreement (the rules of the fund) by which the trust or agency in question has been created, observe the utmost good faith and exercise the care and diligence required of a trustee in the exercise or discharge of his or her powers and duties; and

(c) may not alienate, invest, pledge, hypothecate or otherwise encumber or make use of the funds or trust property or furnish any guarantee in a manner calculated to gain directly or indirectly any improper advantage for himself or herself for any other person to the prejudice of the financial institution (the retirement fund) or principal concerned.

4.4. If the “intermediary” was a “representative” of an insurance company, the position would be different. He or she would be obliged to act in the best interests of the insurer but then could not purport to act as an advisor to the insured (the fund).

4.5. South African common law governs the conduct of persons who owe fiduciary duties to others as a consequence of the nature of their relationship with those others. The category of persons who assume such fiduciary duties is not a fixed one but a fiduciary relationship will be indicated if the person in whom it is thought to be reposed has scope for the exercise of some discretion or power, the power or discretion can be used unilaterally so as to affect the beneficiaries’ legal or practical interests and there is a peculiar vulnerability of the beneficiary to the exercise of that discretion or power.[20] A person who acts as advisor to a trust or pension fund could be held to be liable for a breach of his or her fiduciary duties towards the beneficiaries of the trust or pension fund in relation to the advice that he or she gives to the trustees of the trust or fund.[21]

4.6. It seems to me that many, if not most, consultants in the employee benefits business fail to appreciate that, in law, they cannot play the dual roles of consultant and salesperson while still complying with their duties to the funds that they advise particularly if they cannot honestly say that they believed that both the product or service sold, sold at the price at which it was sold, was in the best interest of the fund. Those that work for multi-service organisations are often instructed to take steps to maximise their employers’ profits by selling to the funds that they advise products and other services provided by their employer or companies related to it This may already be in breach of the law and I expect that this will be clearly stated in the new statute.[22] Service providers who wish to prepare themselves for the new

---

[20] *Phillips v Fieldstone Africa* 2004 1*All SA* 150 (SCA).

[21] *Jowell v Bramwell Jones* 1999 (1) *SA* 836 (W) and (2000) 2 *All SA* 161 (SCA).

[22] Similar provisions appear in –

1. the US Employee Retirement Income Security Act (ERISA) which in section 404(a)(1)(B) requires that a fund fiduciary “discharge his duties with respect to a plan with the care, skill, prudence and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims.” A fiduciary is a person who –

   1.1. exercises any discretionary authority or discretionary control in regard to the management of a fund or the management and disposition of its assets;

   1.2. provides investment advice for a fee or other compensation (whether direct or indirect) in respect of the assets of the fund or has the responsibility to do so;

   1.3. has any discretionary authority or discretionary authority in regard to the administration of a fund.

See section 3(21). A person who simply calculates benefits is not a fiduciary because he or she has no discretionary authority. Neither is an employer which designs, amends or terminates a fund. *Lockheed* 517 US at 891; *Hughes* 525 US at 443. Attorneys, accountants and actuaries who perform their usual professional functions in relation to a fund ordinarily will not be considered fiduciaries. See cases cited in footnote 25 on page 244 of Zanglein, *Pension Investments and Fiduciary Duties under ERISA*, National Labor College, 2002. They may become fiduciaries if they

environment in which they will be doing business would be well advised to leave their consultants to provide advice and to employ an army of salespersons to do the selling. Better still, consultancy services should be "unbundled" from multi-service organisations so that they can freely fulfil any "whistle-blowing" which may be conferred upon them in terms of the new statute. The UK Pensions Act obliges a fund's actuary and auditor immediately to report in writing to the regulator if he or she "has reasonable cause to believe" there has been a breach of any duty relevant to the administration of the fund in terms of its rules or any law imposed on the fund's trustees, administrator, adviser or any prescribed person acting in connection with the fund and the employer of the fund's members and the breach is likely to significantly affect the exercise by the regulator of any of its functions.[23] Breaches of these obligations are subject to sanction. I think that a similar provision in our law would assist in the better supervision of funds by the regulator and ensure better governance but it could make life difficult for those actuaries who are employed by an organisation which is poorly administering the fund that he or she advises.

## 5. Bundling

5.1. In his report on *Institutional Investments in the United Kingdom*: *A Review* Paul Myners said[24] the frequency with which pension funds obtain investment advice from investment consultants from the same company that employs the fund's valuator can be evidence of an uncompetitive market if the following conditions are fulfilled:

5.1.1. the company would need to be dominant in the market for say, actuarial advice ("the tying service");

5.1.2. there would need to be a mechanism that made the linking of the tying service (the actuarial advisory service) to the tied service (for example, investment management services) – this may take the form of contractual arrangements that require that both services be purchased in the same contract or pricing arrangements with similar effect; and

5.1.3. a situation of sustained profitability in excess of a reasonable rate of return.

---

assume additional functions. An investment manager and an investment consultant will always be fiduciaries to the extent of their authority; and

2. the Canadian Pensions Benefits Act, 1985 which in section 8(4) obliges a fund administrator to exercise the degree of care that a person of ordinary prudence would exercise in dealing with the property of another.

[23] Section 48(1).

[24] At page 66.

5.2. Many umbrella fund and retirement annuity fund arrangements in this country represent these uncompetitive, bundled arrangements. For example, a person who joins a retirement annuity fund may find that, in terms of its rules, the fund must be administered by the fund's sponsor, his or her retirement savings must be invested in an investment product provided by the fund's sponsor, and its risk benefits underwritten by the sponsor, that only an actuary employed by the sponsor may act as valuator to the fund and that, on retirement, only an annuity product provided by the sponsor may be purchased with the member's retirement savings, such as they are at that time. In these circumstances the trustees of the fund are effectively emasculated. They cannot threaten the sponsor with the loss of the fund's business because they do not have the power to remove it. So the members of the fund are at the mercy of the sponsor.

5.3. I raised this argument in a recent debate with an employee of one of these sponsors and she made that point that, if employees who are members of an umbrella fund are feeling exploited by these tied arrangements, they can simply ask their employer to procure their transfer to another umbrella fund. But that is not so simple. Firstly, it requires that the members be vigilant in protecting their retirement savings when that is the job of the fund's trustees. Secondly it requires that the members' employer get involved in the issue when "outsourcing" retirement funding responsibilities was probably one of the reasons it placed its employees in an umbrella fund in the first place. And finally changing an employee's retirement funding arrangements can be expensive and certainly will require management time. It may even entail a change to conditions of service for which the employer will require the employees' consent. So, far from providing employers with an effective solution to their occupational retirement funding problems, some umbrella funds can be the cause of such problems.

5.4. These problems are not, however, an inevitable feature of umbrella retirement funds. An umbrella fund's rules could, and should, provide that its trustees may source investment management, risk, administration and actuarial services from any provider. I am aware of one such fund and it appears to be reasonably successful.

5.5. The *Myners Review* suggests that these "bundled" arrangements would only be evidence of uncompetitive behaviour if it could be shown that they had the effect of producing sustained profitability in excess of a reasonable rate of return. I do not think that it is necessary to prove this. We will never know what would be a reasonable rate of return until these bundled arrangements are broken open and there is true competition amongst service and product providers which will show

what a reasonable rate of return would be in the absence of such arrangements. I think that there it is likely that the new statute that will govern retirement funds will disallow fund rules that require funds to obtain products and services from specified suppliers[25] and will require the trustees of funds to separately appoint these suppliers, even if, in the end, they may all be within one stable. So, for me, an immediate challenge facing service providers is to change the way that they do business to –

5.5.1. reduce their reliance on tied arrangements;

5.5.2. stop requiring those of its employees who provide advice to funds also to sell products and other services to them; and

5.5.3. ensure that each of the products and services offered by it is competitive with reference to quality and price on a stand-alone basis.

5.6. Another practice considered by Paul Myners in his review was the practice of fund managers "outsourcing" some of the services – such as research, information or transaction services - that would otherwise be provided by it to other service providers at the direct cost to the client (the fund). The fund will not scrutinize the second service provider's costs because those costs are negotiated by it with the first service provider, not the fund. Myners suggests that these costs should be built into the first service provider's costs so that it will have an incentive to keep them as low as possible and its client, the fund, will know what it is paying for and what it is getting.

5.7. This, too, is a practice which I suggest that service providers adopt immediately.

5.8. The issue of cost control is inextricably linked to the issue of the governance of retirement funds because good governance requires diligence, an avoidance of conflicts between personal interests and duties and transparency, particularly in relation to costs. For so long as retirement fund trustees are either unable or unwilling - because of their close and dependant relationship with service and product providers - to properly negotiate fees and costs with those providers,

---

[25] Such a provision appears in both –

3. the UK Pensions Act, 1995 which, in section 47(3)(b) requires that the trustees of a fund specifically appoint the following advisors to the fund; the fund's auditor, actuary, (in most cases) fund administrator, asset custodian and (in most cases) legal advisor; and

4. the Australian Superannuation Industry (Supervision) Act, 1994 which, in section 58 says that the governing rules of a fund may not permit its trustees to be subject, in the exercise of any of the trustees' powers under those rules, to direction by any other person.

members of the retirement funds are at risk that their retirement savings will be eroded by costs that bear little relation to the value of the services or products provided to the funds for their benefits. Given the relatively low level of expertise, experience and bargaining power reflected in the composition of many boards of trustees, these boards are heavily dependant on consultants to advise them on a wide range of issues including investment strategies, the choice of products and services that a fund may require and the selection of the providers of those products and services and the prices at which the products and services should be purchased. What funds need is the independent training of those trustees so that they are in a position to act with diligence and subject the advice that they are receiving to proper scrutiny. In my opinion, a fund consultant which has confidence in its own advice should encourage the trustees of funds that it advises to obtain training from external sources so that the consultancy cannot be accused of creating relationships of dependency and acquiescence with fund trustees.

**Conclusion**

6. There's a new world coming for retirement funds and their service providers. The best of the service providers will survive in it without the props of tied arrangements, kick-backs and dependant and compliant trustees. Their products and services will be competitively and "transparently" priced on a stand-alone basis and will be honestly sold by salespersons to funds who will be able to rely on the objective advice given to them by independent consultants as to the worth of those products and services to the funds. These new practices should ensure more cost-effective and more appropriate forms of retirement funding provision for members of retirement funds and should reduce the criticism now being faced by service providers.

___________