# Retirement Fund Reform for Dummies
# By David Gluckman


## ABSTRACT

A number of models for a future South African retirement fund system have been mooted by Government, as well as in various papers and presentations on the structure of a National Social Security System. This paper specifically focuses on the savings element of the wider reform process.

The author argues that the abovementioned models, in the main, significantly underestimate the cost and complexity of the resultant transition from the current dispensation.

The author goes on to argue that the design of a long term retirement savings system is not a pressing priority for the country relative to other social needs. In particular, it makes more sense to first cost and make choices as to social security grants and risk benefits.

The author then argues that there is significant scope to reform the existing retirement fund system by working to change elements of the existing system in a gradual and phased manner. By refining the existing system, the cost and risks associated with transition can be very significantly contained.

Ultimately the aim of this paper is to introduce a practical overlay to what to date have been theoretical debates, and to introduce a practical roadmap to accelerate reform in the best interests of the average working South African.



**CONTACT DETAILS**
David Gluckman
Tel. 021-947-6499
Fax 021-957-1109
e-mail davidg@sim.sanlam.com

# PREFACE

*"In theory there is no difference between theory and practice. In practice there is."*
*Yogi Berra, American Baseball Player*

This is the second paper that I have presented to the Actuarial Society - the first being *Retirement Fund Conversions - Challenges and Risks* in 1997. The gap of 12 years between papers implies one important point – I am no academic or researcher. Instead I regard myself as firstly a concerned South African citizen and secondly a practitioner within the retirement funds industry.

My motivation to write this paper is that my practical experience informs my view that the South African retirement fund reform debate is going around in circles, and that a practitioner's input to the debate is essential.

There has been a huge amount of high quality research on social security and retirement fund reform from Government (specifically the Departments of Social Development and National Treasury), various academics and the private sector. In researching this paper, I was continually impressed with the detailed research that has been undertaken. But this comes with a danger – the possibility of not seeing the wood from the trees. There is also the danger of implementing an attractive theoretical model that does not deliver value in practice e.g. in our own industry, we do not have to go back any further than the 2001 surplus legislation for a costly example of legislation that did not achieve its stated and laudable objectives.

I acknowledge that some of my concerns could conceivably already have been considered and possibly addressed in the ongoing discussions within Government circles. But then again I am not privy to such discussions, so it is difficult for me to comment. The 2009 Budget Review appears to adopt a much more pragmatic, and in my view sensible, approach to many of the challenges facing our industry, and appears to indicate that the various stakeholders are moving closer to a high level consensus on the way forward. These are encouraging signs.

My approach in writing this paper is to deliberately keep it as short and to the point as possible. I aim to highlight the salient issues arising from others' research, and to propose a practical roadmap forward. My fear is that a more academically comprehensive paper would simultaneously introduce the danger of being bogged down in detail rather than proposing practical solutions.

I sincerely hope no one takes offence at the title of this paper. I number myself amongst the dummies – i.e. concerned South Africans who question whether the current reform discussions will be practically implementable within acceptable cost parameters.

I would also like to emphasise that all views in this paper are mine alone, and do not necessarily reflect the views of my employer.

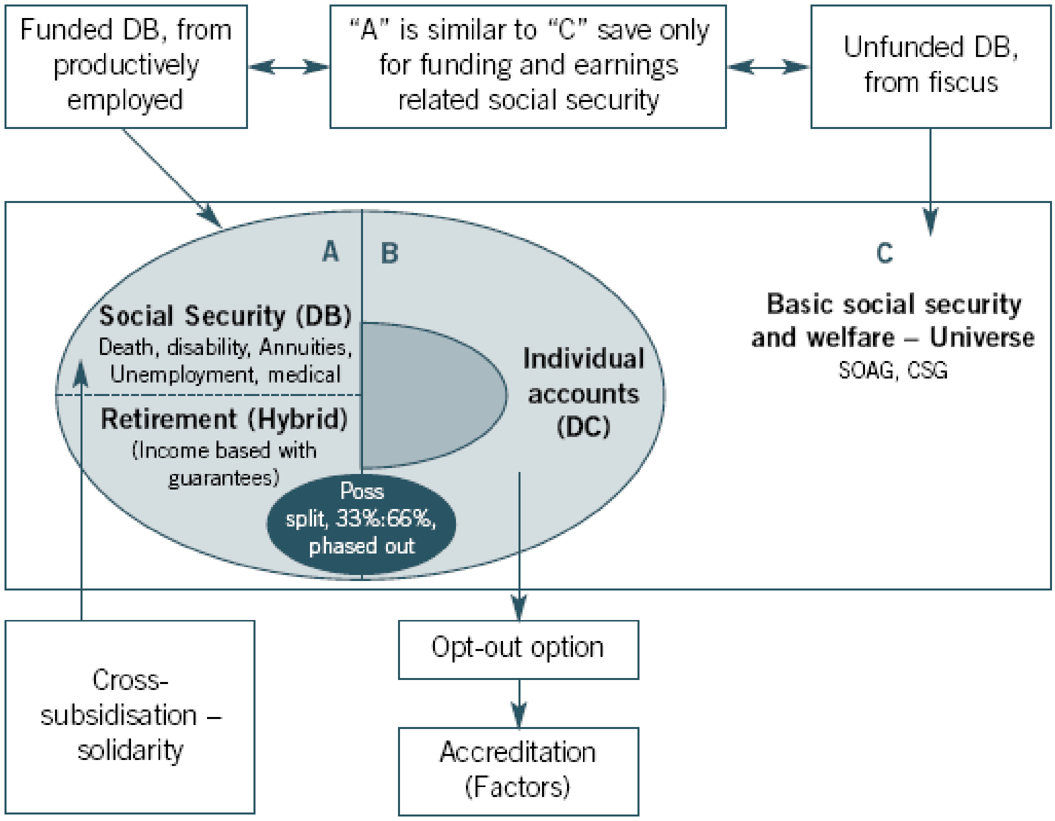
I write this paper as we enter a general election month. My hope is that the paper in some small way assists our incoming Government in tackling the many challenges it will face including, but by no means limited to, social security and retirement fund reform.

**David Gluckman**
**Cape Town**
**April 2009**

## 1. THE PROPOSED MODEL IN A NUTSHELL

This paper specifically focuses on the savings element of the retirement fund reform process. Other elements of the reform process such as social grants, death benefits, disability benefits, national health insurance and post-retirement medical protection are beyond the scope of this paper except to the extent these potentially impact the savings element.

**DIAGRAM 1**




*Source: Masilela E, Sanlam Employee Benefits Information Sheet, April 2008*

Diagram 1 shows a proposed model arising from discussions within Government's Inter-departmental Task Team (IDTT).

In summary, we could have the following proposed new retirement funding dispensation[1] :

1. A non-contributory social old age pension (SOAP) funded on a pay-as-you-go basis from tax revenues.
2. A mandatory DB risk component covering social security grants and other risk benefits supported by a possible contribution rate of 3% of earnings below a to-be-determined upper threshold.
3. A mandatory DB savings component within a centralized system supported by a possible contribution rate of 6% of earnings below a to-be-determined upper threshold with no opt-out option.

[1] Contribution rate splits as indicated in research by Rusconi published by the Department of Social Development in 2007.

4. A mandatory DC savings component supported by a possible contribution rate of 6% of earnings below a to-be-determined upper threshold with the possibility of an opt-out option to accredited funds.
5. Private funding of additional retirement on a voluntary basis presumably with zero or very limited tax incentives.

The thinking would be to have the entire arrangement, or alternatively key elements thereof, administered centrally as a new national social security fund with SARS mentioned as a possible provider of centralized administration services.[2]

An important practical consideration is that the vast majority of employers and company shareholders will almost certainly refuse to underwrite any new DB promises. Therefore any compulsory contributory DB component of the new dispensation will have to be underwritten by Government (i.e. future generations of tax payers), and opt out from this component will not be a realistic option. The introduction of a contributory DB component will thus introduce discontinuities, and hence have significant practical and financial implications for all existing registered retirement funds. A contributory DB component is thus inconsistent with the gradual retirement fund reform process recommended in Section 4 below.

**Key Dummy Takeaways:**

- ***It is assumed that 3% of earnings will be sufficient to cover the desired menu of social security grants and other risk benefits.***
- ***It is assumed that it is cost viable to support a mandatory system administering paid-up benefits for historic retirement fund savings, a DB savings component and a DC savings component.***
- ***A contributory DB component introduces discontinuities, and is thus inconsistent with a gradual retirement fund reform process.***

[2] National Treasury : *Social Security and Retirement Fund Reform, Second Discussion Paper*, February 2007

## 2. TRANSITION

Although my formal actuarial studies were many years ago, I vaguely recall formulae such as Makeham's and Gompertz's laws. Here is my own attempt at an actuarial formula:

Gluckman's law:
*Net Utility arising from Retirement Fund Reform = Gross Utility arising from Retirement Fund Reform – Cost of Transition*

All the retirement fund reform modeling work I have seen so far assumes that we start from a clean slate. This is an invalid assumption. At best the point that transition challenges must be considered sometime in the future is mentioned in passing. This is a grave mistake given that the cost of transition will almost certainly vary substantially depending upon the system design that is chosen. Gluckman's law implies that transition challenges must be considered up front.

The 2005 annual report of the Registrar of Pension Fund reveals that there were then 13,390 registered retirement funds comprising 9.3 million members and R1.3 trillion assets. These numbers are outdated, and we would expect that consolidation would subsequently have reduced the number of funds (e.g. the FSB recently estimated that there currently remains only 6,000 active funds in motivating industry levies for the 2009/2010 financial year), and we also note that the membership figures include significant double-counting. But in any event, it is clear that the existing retirement funds industry is substantial relative to the size of our employed population or South Africa's Gross Domestic Product (e.g. Rusconi estimates industry assets totaled in excess of 80% of GDP during 2007[3]).

The main transition options are:

1. Commence new system, but leave all accrued savings behind in current funds.
2. Commence new system, and compel transfer of all accrued savings from current funds to new dispensation.

2008 witnessed mounting rumours and unfounded fears by the public that Government was devising a plan to nationalise all retirement fund savings by 2010. This in turn resulted in many retirement fund members demanding to access their accrued savings immediately. In response, Government and Labour felt compelled to issue a Joint Press Statement dated 27 June 2008 wherein the nationalisation plans were strenuously denied. This effectively implies that transition option 2 can be discarded (which implies we do not need to consider further the potential for significant disruption to financial markets that could arise from any such compulsory transfer of assets on this unprecedented scale).

Therefore, on the assumption that the vast majority of South African retirement fund members will not be in a position to save anything above the mandatory contribution levels, this implies we will have millions of members participating in the new dispensation, and with paid-up benefits remaining behind in their current funds.

Southey and Buck analysed data in respect of 2.3 million members of South African retirement funds, and estimated that 80.7% earned less than R120,000 per annum (R120,000 being a possible upper threshold for contributions to the new mandatory system). It thus seems reasonable to assume at least 80% of all members will not be in a position to continue to contribute to private funds after the proposed reforms are implemented. If we assume a double-count of membership of 1.4, this then implies that we can expect in excess of 5 million paid-up accounts to remain in the current funds.

Southey and Buck's analysis also reveals that more than 85% of members are age 50 or younger with the biggest proportion in their thirties.

Consider the combined risks arising from a potential 5 million paid-up members, the long average period to retirement being in excess of 20 years, the known practical difficulty of keeping track of paid-up benefits together with low levels of financial sophistication of South Africans. It is apparent that we would potentially sit with millions

[3] *South African Institutional Investments – Whose Money is it Anyway?*

of unclaimed paid-up accounts in future years. In my view this should be included in any quantification of the cost of such an approach to transition.

I have reworked the analysis of Southey and Buck to try put a high level cost estimate on these risks as shown in the table below.

**TABLE 1**

| Salary Band | # Members | Average Liability | Total Liabilities (R'million) | Unclaimed Benefits Risk Factor | Estimated Cost of Unclaimed Benefits if Made Paid-up (R'million) |
|---|---|---|---|---|---|
| <60k | 943,600 | R 30,840 | 29,101 | 25% | 7,275 |
| R60k - R120k | 247,800 | R 142,458 | 35,301 | 10% | 3,530 |
| R120k - R180k | 105,000 | R 295,146 | 30,990 | 0% | 0 |
| R180k - R500k | 91,000 | R 415,474 | 37,808 | 0% | 0 |
| >500k | 12,600 | R 1,001,788 | 12,623 | 0% | 0 |
| **Sample Total** | **1,400,000** | **R 104,159** | **145,823** | | **10,805** |

*Source: Analysis by Southey & Buck 2007 (data reworked)*

The table works with the subset of 1.4 million members in respect of whom Southey & Buck were supplied complete data. These members held retirement fund investments comprising almost R146 billion at the time data was extracted in 2007, of which more than R64 billion was in respect of members earning less than R120,000 per annum.

The Unclaimed Benefits Risk Factors reflect my guesses on the proportion of moneys that would ultimately be reported as unclaimed were these benefits to be made paid-up until retirement age in their existing funds. I confess it is a guess what factors to apply, but I suggest it is reasonable to suggest these Unclaimed Benefits Risk Factors would decrease as salary (a proxy for financial literacy) increases. Based on anecdotal evidence of the practical problems and industry experiences associated with tracing paid-up members upon their eventual retirement (yes, further research is recommended!), I suggest my guesses above are not overstated.

In any event, applying the above Unclaimed Benefits Risk Factors results in an estimated cost of R10.8 billion for these 1.4 million members. This could mean a total industry cost in the R40 billion to R60 billion range if we assume the Southey and Buck data is representative of the wider industry. This is certainly not an insignificant number that we can ignore. In any event, I suggest such a number must be included in any estimate of the cost of transition.

Given that I am not aware of anyone raising this particular concern to date, and the risk above is but one element of the total cost of transition, I conclude that there is a real danger that the total cost of transition might well be significantly underestimated by policymakers.

As far as I am aware no country has to date successfully transitioned from a mature private sector system funded mainly on a DC basis to anything close to the model suggested in Section 1 above. It is important to appreciate that the direction of the proposals in Section 1 above is opposite to that embarked upon by various South American and Eastern European countries[4] where the direction was away from underfunded centralized DB systems towards privatized DC arrangements (which I would suggest is a much simpler direction from a transition costs and risk management perspective).

[4] Chile perhaps being the most famous case study cf. Pinera's paper *Empowering Workers : The Privitisation of Social Security in Chile*, 1996.

It is not apparent to me how the transition challenges can be addressed. My view is that the risks and costs associated with either of the two main transition options identified above are simply too big. I would strongly argue against either option.

**Key Dummy Takeaways:**

- ***The cost of transition is an integral part of the decision-making process of choosing any model for a reformed retirement fund system, and must be considered at the outset.***
- ***If the cost of transition is too high, it is theoretically possible that the reform process will result in negative net utility.***
- ***Given that industry assets total in excess of 80% of GDP, we better think very carefully on how to mitigate any transition risk.***
- ***Retaining millions of paid-up benefits in the current funds is not recommended.***

## 3. SHOULD RETIREMENT FUND REFORM BE A PRIORITY?

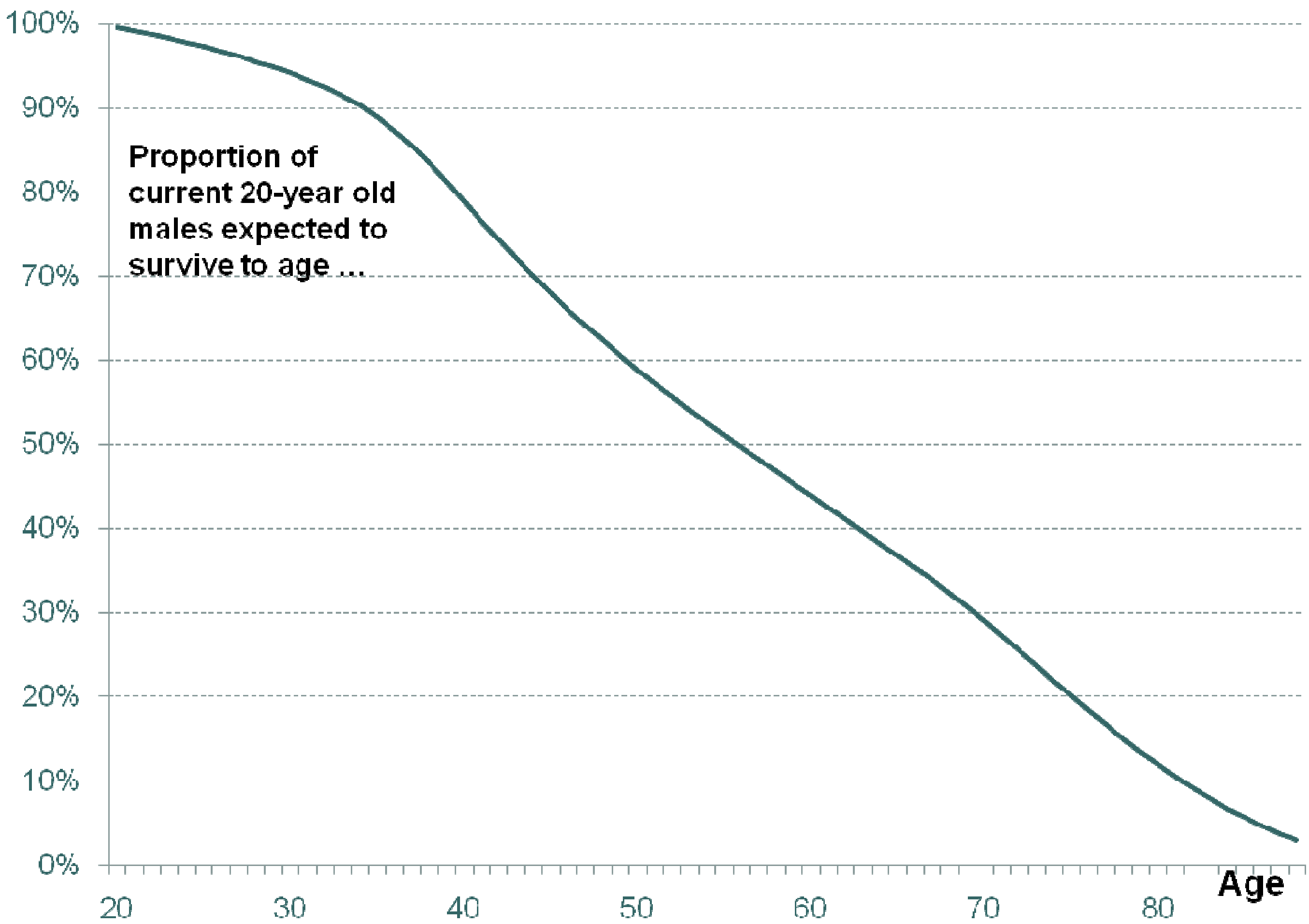
We have shown is Section 2 above that transition between the current and new dispensation will be very costly and very risky. If so, I would argue that we should only consider proceeding with such transition if the end goal is very important for our country.

So how important is retirement fund reform in the South African context?

Whilst it is no doubt desirable that our citizens retire with reasonable financial security and in a position to live their retirement years in relative comfort, this in itself does not make retirement fund reform a priority issue. There are many competing priorities including education, health, poverty alleviation, housing, job creation, etc.

Where should retirement fund reform rank on such a pecking order?

**DIAGRAM 2**

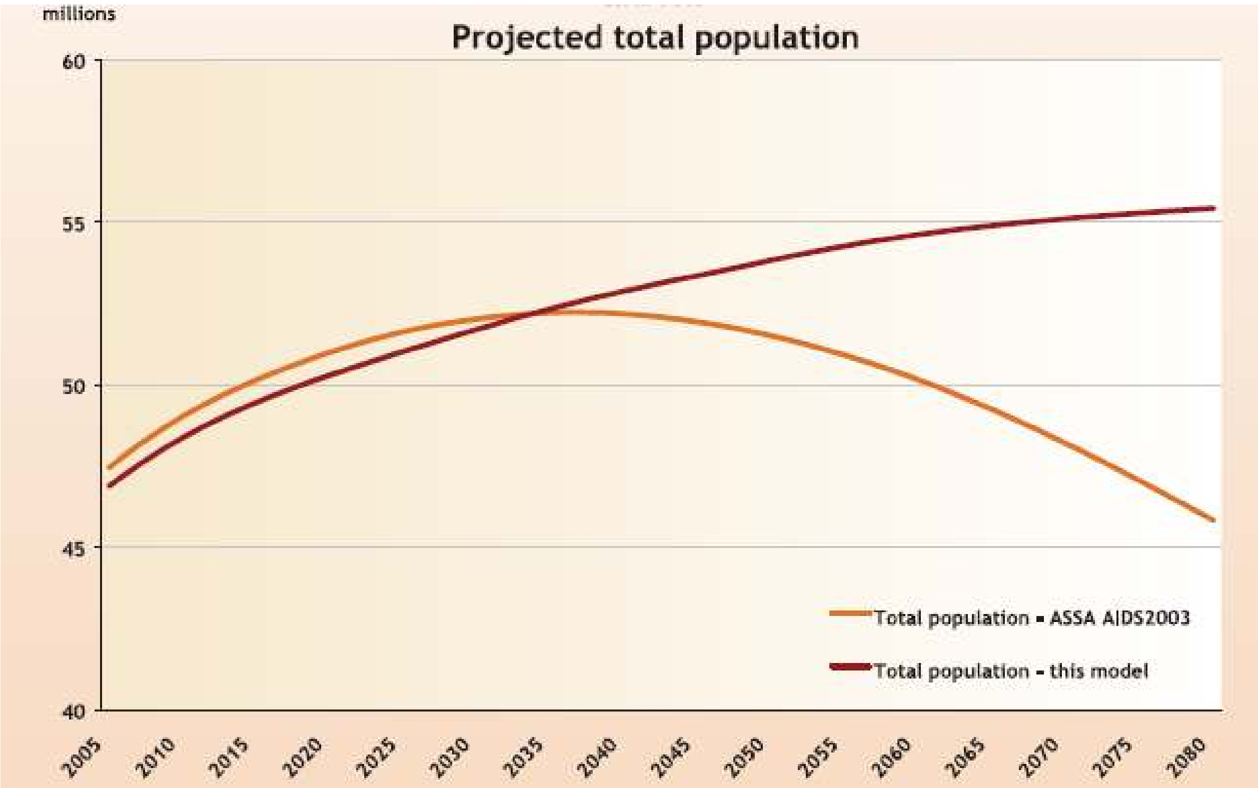



*Source: ASSA2003 model, whole SA population, standard assumptions*

Diagram 2 shows that between 30% and 40% of 20-year old males are expected to reach retirement age.

Given that the new dispensation will start from a zero base, this is an important cohort within the population. Older workers' needs are not going to be entirely met by the new dispensation anyway given they will have a proportion of their retirement savings accrued under the current dispensation. There are no plans on the table to augment accrued savings levels, but rather to introduce mandatory savings for future service. The current 20-year olds will be the first cohort who will retire at some point in the future from the new dispensation, and Diagram 2 indicates that well over half of this cohort will never reach retirement age.

**DIAGRAM 3**



*Source: Department of Social Development, September 2007*

During 2007, the Department of Social Development (DoSD) published a 75-year model for the proposed new retirement fund dispensation based on the modeling work of an actuary, Rob Rusconi. Diagram 3 is taken directly from that paper.

The diagram is a perfect illustration of the difficulty of modeling over such a long period into the future. Two actuarial models give two very different projections over such a long period!

Immigration is assumed to be net zero into the future in both models. The DoSD paper qualifies their model by stating that "immigration will be positive and one of the strongest drivers of total population growth, but modeling immigration with confidence is difficult because one needs to make assumptions not only on the numbers but on the age, gender and socio-economic standing of immigrants".

This is perhaps not at all surprising to actuaries, but it might well be to the public who rely on our work. We need to shout it from the rooftops – **ALL ACTUARIAL MODELLING WORK OVER SUCH LONG PERIODS INTO THE FUTURE WILL INEVITABLY RESULT IN A SITUATION WHERE THE ACTUAL EXPERIENCE DIFFERS MATERIALLY FROM THE ASSUMPTIONS.**

Actuarial modeling is important. It helps in setting direction, but in the end it's just modeling. We must not underestimate the dangers arising from policymakers incorrectly confusing modeling projections and fact, or alternatively significantly underestimating the probability of deviation from best estimates.

I would argue we can never expect the assumptions underlying a 75-year model to play out in actual experience. 75 years ago was 1934 – who then could have modeled the possibilities that could arise from subsequent events such as the Second World War, the Cold War, space travel, computing power, the Internet, the civil rights movement, the independence struggles throughout Africa, etc? Given that the pace of technological and scientific development is continually accelerating, I would be more confident of being able to predict the world status in 2009 starting from 1934 than predicting the world status in 2084 starting from 2009!

From where does the desire to focus on retirement fund reform emanate?

**TABLE 2**

| Years of contribution at time of retirement | Replacement ratio |
|---|---|
| More than 35 | 38% |
| 30 - 35 | 32% |
| 25 – 30 | 28% |
| 20 – 25 | 23% |
| 15 – 20 | 18% |
| 10 - 15 | 15% |

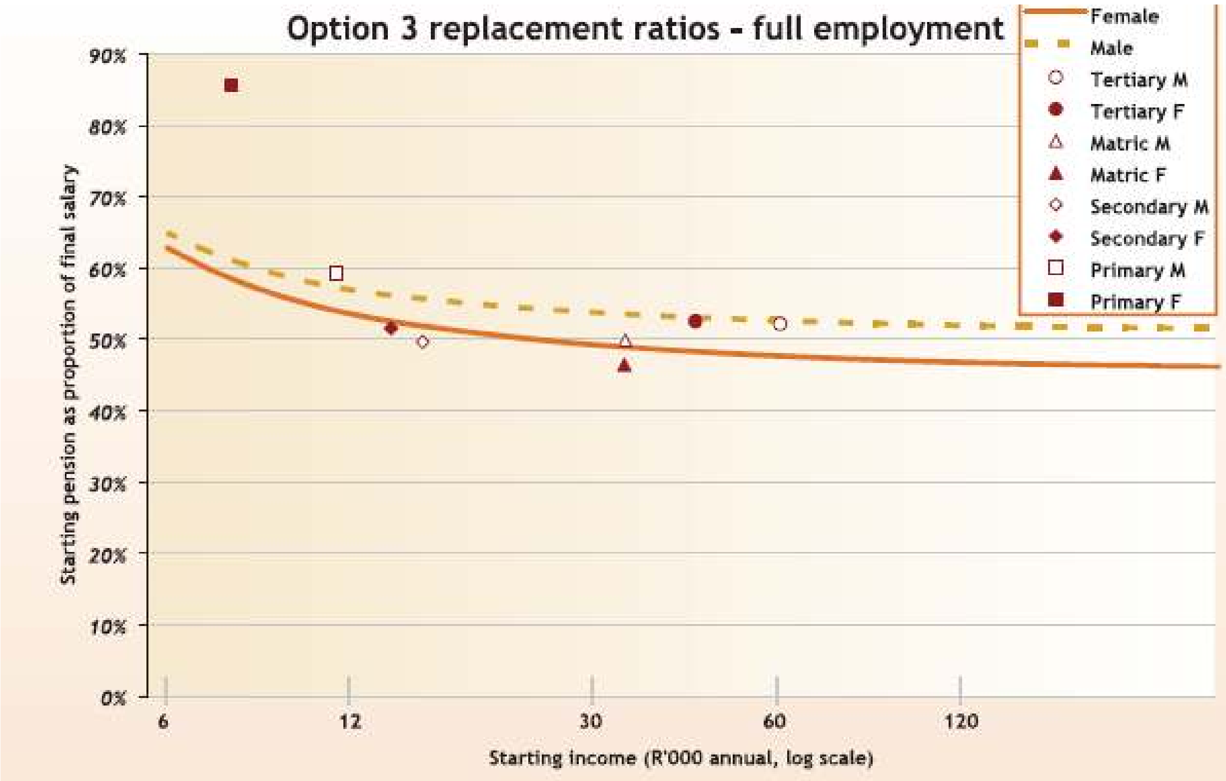
*Source: Masilela E, 2008 Sanlam Employee Benefits Benchmark Symposium*

Elias Masilela, at the 2008 Sanlam Employee Benefits Benchmark Symposium, presented the above replacement ratios as typical of those arising from South African retirement funds. Given that many early leavers often encash accrued retirement fund savings upon leaving jobs rather than preserving these savings, the above findings are consistent with the much-vaunted statistic that the replacement ratio emerging upon retirement from South African retirement funds is below 30%.

In the same presentation, Masilela mentions that Government is targeting a minimum replacement ratio of 40%.

This is not too dissimilar to the DoSD modeling using the split of the overall 15% of earnings contribution as described in Section 1 above, and with the mandatory DB component having an accrual rate of 0.75% of earnings per year of service – this being the recommended model in this paper.

**DIAGRAM 4**




*Source: Department of Social Development, September 2007*

The DoSD model shows projected replacement ratios at between 45% and 50% for people commencing employment in the income band R30,000 to R120,000 annual income.

But as stated beforehand, the outputs from any 75-year model must be used with extreme caution. Aside from the extreme uncertainty arising from projecting over such a long period, there are big question marks on the underlying assumptions e.g.:

- The net zero immigration assumption is a key concern identified within the DoSD paper.
- The SOAP has already changed from the time of the DoSD modeling such that it commences for males at age 60 rather than age 65.
- Is a 3% allocation of earnings to risk benefits realistic?

On the latter question, it is in my view essential that modeling of the proposed risk benefits package be undertaken as a matter of some urgency, and the results be subjected to public scrutiny. It does not make sense to me to implement a new retirement savings system assuming these risk costs will amount to around 3% of earnings, and then to discover later that the actual risk costs will be much higher.

Based on my knowledge of risk costs in the private sector, and taking account of population risks, my intuition is that affording a decent package of risk benefits within the envisaged cost allocation will be extremely challenging. In fact, I am of the opinion that such costs could easily amount to significantly higher than the envisaged 3% of earnings allocation unless risk benefits are significantly curtailed.

Affordability becomes an even greater concern if other possible desired risk benefits are to be implemented e.g. the raising and extension of the current package of social grants, the mooted National Health Insurance system and provision of post-retirement medical cover.

My strong recommendation is that a basic package of risk benefits is agreed and actuarially modeled before any final decisions are taken as to the structure of any new retirement funding dispensation.

It is also useful to consider what proportions of our working population are potentially impacted by the mooted retirement fund reform process.

**TABLE 3**

### Income distribution of employed persons (aged 16 and above)

| Income Group | Formal (000s) | Informal (000s) | Combined (000s) | % Total | Cumulative % Total |
|---|---|---|---|---|---|
| None | 7 | 3 | 10 | 0.1% | 0.1% |
| R1-R200 | 56 | 38 | 94 | 0.9% | 1.0% |
| R201-R500 | 217 | 136 | 353 | 3.6% | 4.6% |
| R501-R1 000 | 926 | 224 | 1150 | 11.6% | 16.2% |
| R1 001-R1 500 | 962 | 114 | 1076 | 10.8% | 27.0% |
| R1 501-R2 500 | 1592 | 149 | 1741 | 17.5% | 44.6% |
| R2 501-R3 500 | 1039 | 34 | 1073 | 10.8% | 55.4% |
| R3 501-R4 500 | 763 | 17 | 780 | 7.9% | 63.2% |
| R4 501-R6 000 | 765 | 8 | 773 | 7.8% | 71.0% |
| R6 001-R8 000 | 623 | 8 | 631 | 6.4% | 77.4% |
| R8 001-R11 000 | 571 | 6 | 577 | 5.8% | 83.2% |
| R11 001-R16 000 | 366 | 4 | 370 | 3.7% | 86.9% |
| R16 001-R30 000 | 245 | 1 | 246 | 2.5% | 89.4% |
| R30 001+ | 242 | 2 | 244 | 2.5% | 91.9% |
| Don't know | 226 | 11 | 237 | 2.4% | 94.2% |
| Refuse | 480 | 8 | 488 | 4.9% | 99.2% |
| Unspecified | 79 | 6 | 85 | 0.9% | 100.0% |
| **Total** | **9159** | **768** | **9927** | **100.0%** | |

*Source: Masilela E & Kaniki S 2009 (calculations based on 2007 Labour Force Survey)*

Table 3 indicates, for example, that 63.2% of employed South Africans earned less than R4,500 per month in 2007.

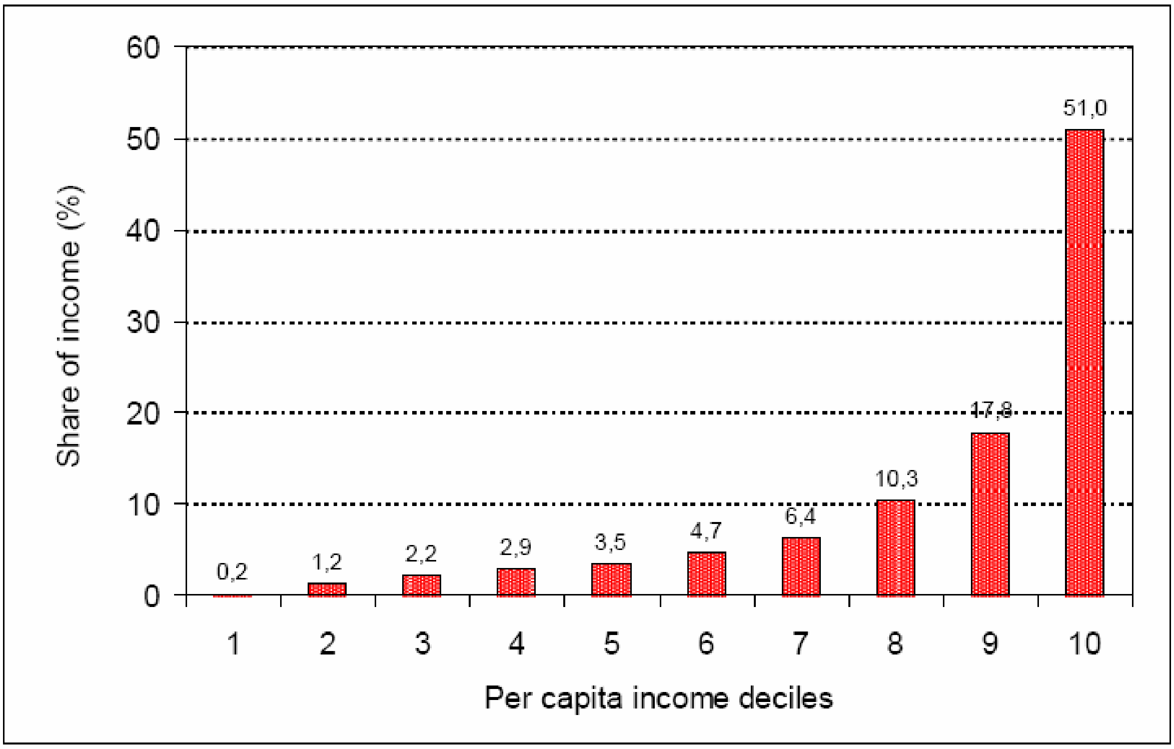
Let us consider a worker earning R4,500 per month in 2007 terms. If we design a new retirement savings system that targets a 40% replacement ratio, that requires a pension of R1,800 per month in 2007 terms. The SOAP was R870 per month in 2007 i.e. approximately half the target. For a married worker earning R4,500 per month whose spouse earns no income (not an unlikely scenario), their combined family SOAP would almost achieve the targeted replacement ratio. But even ignoring the spouse's SOAP, one must question whether it is cost efficient to have a DC component and a DB component to deliver the desired additional R930 per month (in this example) pension. This is a separate and massive topic, but I would like to make a few key points:

- DB and DC do not impact the size of the overall cake, but merely how the cake is apportioned between participants.
- DB involves South Africans making a financial commitment to fund the promised benefits, the cost of which is completely uncertain in the light of the reservations about long term modeling as expressed above.
- The main argument against DC is the unpredictability of the final pension. I would argue that if that is the concern, why do we have to rush in and make an unquantifiable DB promise right now that we might not be able to afford? The first full payouts from the new dispensation will be in around 40 years time. Why not start DC, track how we are doing, and if need be consider implementing DB underpins at a later stage – say in 20 to 30 years time when we will have much more information to make more informed and better decisions.

Table 3 also shows that less than 3 million people earn above R4,500 per month. Given that the SOAP to a very large degree suffices for retirement fund provision for those earning less than this threshold, we conclude that this is the portion of our population that could potentially be served by retirement fund reform.

**DIAGRAM 5**

Distribution of household income across deciles




*Source: Income & Expenditure of Households Survey 2005/2006*

Diagram 5 highlights the need to prioritise. The top 10% and bottom 90% of South African households each account for approximately 50% of total household income. Where is it more important to prioritise our efforts and focus our intellectual capital – the top 10% or the bottom 90% of households?

It should be noted that I am not stating that it is not important to work towards ensuring adequate retirement provision for the proportion of the population who should rightly save for retirement provision above and beyond the SOAP. Rather these citizens' needs can be better addressed, at lower cost and risk, via refinement of the existing private sector retirement funding system. I also argue that, at a macro level, the wider social security needs are more urgent priorities.

If any further argument is needed, look no further than Table 4 below. South Africa has a very high unemployment rate (in fact it might be much higher than the official figures above as *Brot fur die Welt* state a broader definition of unemployment of 43%). Clearly any retirement fund reform will not help the unemployed.

**TABLE 4**

International comparisons – labour force and unemployment rates

| Country | Year | Labour Force (000s) | Unemployment Rate |
|---|---|---|---|
| Argentina | 2006 | 11,052 | 9.5% |
| Brazil | 2004 | 90,962 | 9.1% |
| Chile | 2005 | 6,345 | 6.9% |
| Czech Republic | 2005 | 5,175 | 7.9% |
| Hungary | 2006 | 4,247 | 7.5% |
| Korea | 2005 | 23,744 | 3.7% |
| Mexico | 2006 | 43,216 | 3.2% |
| Philippines | 2006 | 35,804 | 7.3% |
| Poland | 2006 | 16,937 | 13.8% |
| Singapore | 2006 | 1,881 | 4.5% |
| **South Africa** | **2007** | **16,984** | **25.5%** |
| Turkey | 2005 | 24,566 | 10.3% |
| **Average** | | | **9.1%** |

*Source: Brot fur die Welt (Frye I) 2008 based on research published in 2007 by the International Labour Organisation.*

A related point is that it is essential for Government policy to continue to work in the direction of stimulating economic growth and raising employment levels. As stated above, DB or DC arguments are in essence simply about how the cake is apportioned between participants. A more urgent priority must surely be to increase the overall size of the cake. Increased employment levels would, over the long term, not only increase the proportion of the population who can afford to save for retirement, but would also augment the tax base thus allowing the SOAP to be increased in real terms over time (which in turn better meets the retirement needs of a significant proportion of our population).

**Key Dummy Takeaways:**

- ***The majority of 20-year-olds are not expected to survive to retirement age, and hence for them retirement fund reform is not a priority relative to their other social security needs.***
- ***The modeling of any new dispensation necessarily involves significant guess work (aka assumptions) and simplifications, and hence is unlikely to pan out in practice. In fact, it is highly likely that the actual experience will deviate very materially from that assumed.***
- ***The cost of social grants and other risk benefits could easily amount to much higher than the assumed 3% of earnings allocation, and choices will have to be made.***
- ***Actuarial modeling of the risk benefits costs is an urgent priority as an essential precursor to the design of any new retirement savings dispensation.***
- ***The SOAP provides a reasonable base retirement pension, and in fact even with no additional retirement provision is above what many earn during their working lifetimes (e.g. 16.2% of working population earned less than R1,000 per month in 2007 not to mention the additional 25% - 43% of the working age population who are unemployed).***
- ***Poverty is very high in South Africa, and one should question prioritizing long term retirement provision (based on many assumptions that are impossible to make with confidence) and impacting a small minority of the population over short term needs of the majority of the population.***
- ***I would then argue let's first address the short term needs and decide on an affordable package of social grants and other risk benefits. This should include consideration of the policy in respect of future increases to the SOAP.***
- ***Thereafter if it can be shown that additional mandatory retirement fund provision is affordable, we can try structure a retirement fund system that is cost efficient within the quantified affordability limits.***
- ***Given the very high transition risks as discussed in Section 2 above, it would be ill-advised to accept these transition risks and costs to implement a new dispensation that we cannot model with confidence, that will at best produce net utility far into the future (and maybe not), and that potentially takes our "eye off the ball" as to other more pressing priorities.***

# 4. WHAT REFORM CAN WORK?

*"Let us therefore brace ourselves to our duty, and so bear ourselves that if the British Empire and its Commonwealth last for a thousand years, men will still say, 'This was their finest hour.' "*
*Winston Churchill, British Statesman and Prime Minister, 1940*

Many gradual reforms are possible to move the retirement funds industry closer to the desired end state. It is beyond the scope of this paper to consider all possible reform initiatives. Rather I aim to cover a few possible ideas to demonstrate just how many possibilities there are to move in the desired direction.

We have demonstrated that implementing a new retirement funding dispensation for South Africa is a less pressing priority than many other social and economic challenges, and also that the cost and risk of transitioning between the current and proposed new retirement funding dispensations is unacceptably high.

Does this imply that no reform is possible?

I would argue that once we come to the realization that a new dispensation is unnecessary, there are a number of relatively quick wins that are achievable. Furthermore we can commence with gradual and phased reform initiatives virtually immediately; as opposed to trying to design an entirely new system including a new legal framework and a new administration capacity - initiatives that could easily take years to get off the ground. By way of example, it is more than two years since former President Mbeki announced the new reformed dispensation would be implemented by 2010, and the subsequent progress towards this goal is not obvious.

There is also no doubt in my mind that reform of the current dispensation is both necessary and desirable. But I argue for gradual and staggered reform. Clearly there are imbalances and distortions that need to be addressed. The very low retirement funding coverage for people working in the informal sector is a great concern and is but one example of an imbalance. Rusconi in his 2008 paper[5] also makes a very good case that there currently exists various market distortions, e.g. relative market shares of passive versus active investment strategies. We can never be satisfied when the retirement fund industry is yielding an average replacement ratio in the region of 30%, and we must work steadily towards raising this replacement ratio and to extending coverage to a greater proportion of all South Africans with the aim of minimizing the probability of poverty in retirement.

President Mbeki announced the following broad principles for any reform:

1. Equity
2. Pooling of Risks
3. Mandatory Participation
4. Administrative efficiency
5. Solidarity

What I have argued in the previous sections of this paper is broadly consistent with the abovementioned five principles. Solidarity refers to social grants and other risk benefits, which I have argued in Section 3 are a more pressing need than retirement savings reform. The current dispensation with its mix of a mainly DC private sector and a DB grant combines the principles of equity and pooling of risks in a manner that is broadly suitable given the realities of our economy. Whilst we do not have mandatory participation, we do have a very large private sector retirement fund sector that provides extensive coverage of our working population.

Improving administrative efficiency is the area where I believe some quick wins are possible. The aim would be to reduce costs (without sacrificing service delivery) thereby improving new retirement payouts to members.

National Treasury suggests that the primary causes of existing cost structures might be:

- low levels of competition and transferability between products,
- poor disclosure,
- low levels of consumer education,

[5] *South African Institutional Investments – Whose Money is it Anyway?*

- highly complex benefit design, and
- weak governance arrangements combined with significant vertical product integration.

It is not difficult to agree with these points.

A starting point in any debate on costs is Rusconi's research.

**TABLE 5**

| | Charge Ratio | | Reduction in Yield | |
|---|---|---|---|---|
| | **Low** | **High** | **Low** | **High** |
| Retirement funds (narrow range) | 17.0% | 27.1% | 1.04% | 1.65% |
| Retirement funds (wide range) | 13.4% | 38.4% | 0.81% | 2.36% |
| Individual policies | 26.7% | 43.2% | 1.50% | 2.80% |
| Unit trust products | 22.3% | 32.5% | 1.20% | 1.95% |

*Source: Rusconi RD, 2005*

Retirement funds have the lowest cost structures with the vast majority of funds' reductions in yield falling in the range from 1.04% per annum to 1.65% per annum.

These charge structures are reasonable compared to other voluntary savings systems, although Rusconi concludes that mandatory savings systems produce even lower cost structures.

Having said this, it is not clear that Rusconi is comparing apples-with-apples, costs being only but one element of any system's overall value proposition.

But in any event, we have already concluded that the implementation of a completely new retirement savings dispensation for South Africa is too costly and too risky, and also is not a high priority for the country.

Rusconi calculates that every 0.1% per annum reduction in costs results in an improved retirement outcome of 1.9%.

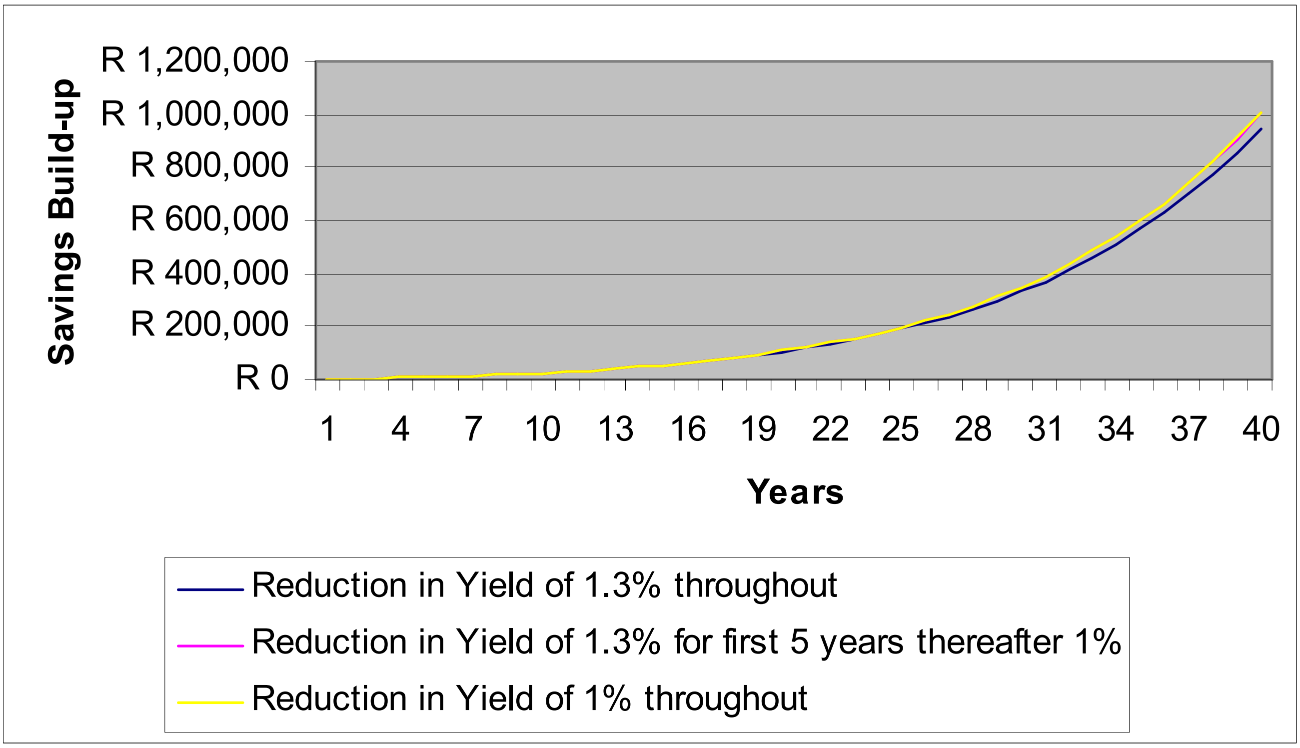
McCarthy ended his 2008 presentation to the Sanlam Employee Benefits Benchmark Symposium with the words "charges, charges, charges" – i.e. it is vital for our industry to concentrate on bringing costs down. In response to a question from the audience, I recall he then suggested an overall 1% reduction in yield[6] as a reasonable target. Given that the mid-point of the narrow range of Rusconi's actual cost estimates is 1.3%, this suggests that a reasonable medium term goal is to bring down total charges by 0.3% per annum across the entire industry which would in turn raise long term retirement payouts by approximately 5.7%.

I support such tangible goals – for the practitioner these help in translating theoretical discussions into practical action steps.

Diagram 6 represents the impact of differing charge levels over a 40-year term using consistent assumptions as did Rusconi in his 2005 research (i.e. 10% gross investment return and 7% salary increases). It shows the savings build-up for 3 different levels of charges for an initial monthly contribution of R100.

[6] Rusconi in 2007 research published by the DoSD suggests, as a first step for discussion, a long-term cost target of 0.6%of assets per annum for very large arrangements. McCarthy's 1% suggested target is recognized as an off-the-cuff comment, and in any event significant deviation around the mean would be expected.

**DIAGRAM 6**




*Source: Own calculations*

It is interesting how closely the yellow and pink lines track each other. A reduction in yield of 1.3% per annum throughout the 40 year period equates to a charge ratio of 25.3%. If the reduction in yield reduces to 1.0% per annum from the start, the charge ratio reduces to 20.3%. If the reduction in yield remains at 1.3% for the first 5 years, and only thereafter reduces to 1.0% per annum, the charge ratio amounts to 20.4%.

The analysis is particularly important when one considers the thinking in many of the mooted models is to design a new retirement savings dispensation for future service only (cf. Section 1 above).

The interesting insight to me is that it is not so important to rush in and reduce costs immediately, but rather to design a system that achieves these cost reductions over the medium to long term. After all, the analysis reveals that achieving the desired savings levels 5 years hence delivers 98.1% of the cost savings that would be achieved by an immediate 0.3% per annum cost reduction.

It is appreciated that these results would be different were accrued assets taken into account, but my point is made in the context of the reform proposals in Section 1 being in respect of future service only. But I calculate that even with an accrued lump sum investment of 1.48 of annual salary[7], a contribution rate of 12% of salary[8] and using a 20-year term to take cognisance of accrued service, the 98.1% figure drops to 82.2% - i.e. the interesting insight mentioned in the previous paragraph still applies.

So how can we bring down costs (perhaps by the mentioned 0.3% per annum reduction in the overall reduction in yield) over, say, the next 5 years?

---

[7] Average liability for 1.4 million members as per Southey & Buck analysis, 2007

[8] Consistent with DoSD proposals as set out in Section 1 above.

The most obvious method is via consolidation of funds so as to enhance economies of scale.

Rusconi's analysis seems to confirm the thesis that bigger funds are more cost effective than smaller funds – e.g. as evidenced by the following table comparing charge ratios in Australia

**TABLE 6**

| Plan Size | Employer-sponsored defined contribution | Employer-sponsored defined benefit | Retail |
|---|---|---|---|
| Small | 15% | 21% | 28% |
| Medium | 12% | 16% | 22% |
| Large | 5% | 7% | N/A |

*Source: Rusconi RD, 2005*

There is very significant scope for consolidation in South Africa, as evidenced by the following table showing the spread of South Africa's registered retirement funds in 2004.

**TABLE 7**

| Number of Members and Pensioners | Number of Funds | Percentage of Total | |
|---|---|---|---|
| | | By Funds % | By Members % |
| 1-20 | 7 354 | 54,8 | 0,4 |
| 21-50 | 2 019 | 15,1 | 0,8 |
| 51-100 | 1 206 | 9,0 | 1,1 |
| 101-500 | 1 829 | 13,6 | 5,0 |
| 501-1000 | 429 | 3,2 | 3,7 |
| 1001-5000 | 434 | 3,2 | 11,7 |
| 5001-10000 | 58 | 0,4 | 5,1 |
| 10001+ | 91 | 0,7 | 72,2 |
| | 13 420 | 100,0 | 100,0 |

*Source : Financial Services Board, 2005*

Clearly consolidation has already started, and it would be interesting to analyse more updated industry statistics preferably with "shell" funds in the process of deregistration already stripped out.

In fact, the desirability of the consolidation trend is not new e.g. the Taylor Commission already noted this possibility in its 2002 report.

And it does appear market forces are already pushing in the direction of the desired consolidation.

The *2009 Budget Review* mentions that "consideration will be given to phasing out provident funds". This will also help with consolidation as anecdotal evidence suggests that there are a vast number of companies that sponsor both pension and provident funds, and in many cases hybrid pension / provident fund structures. The latter, in particular, are extremely cost inefficient structures – double record-keeping merely for the privilege of a different form of payout upon retirement. Whilst protection of accrued rights is always an important consideration when any reform is implemented, one must beware of replicating the expensive UK system where every cohort is subject indefinitely to a different administration regime in an effort to protect accrued rights above all other considerations. I would question whether the form of retirement payout (as opposed to the value of accrued savings, or where the savings are invested) even qualifies as an accrued right. But in any event, very quick wins are possible here e.g. eliminate provident funds but state that future retirees can take up to 1/3$^{rd}$ on retirement payouts in cash subject to a minimum of the accrued amount in provident funds at date of elimination of such funds.

The Rusconi research indicates that the current retirement fund system has a lower cost structure than retail systems such as retirement annuities and unit trusts. This finding is consistent with what one would intuitively expect.

There is another major advantage to group retirement funds that is particularly important in a country such as South Africa where many retirement fund members are financially unsophisticated. This is that the more sophisticated members of the group can protect the more naïve.

Asher confirms this very important point when he states “In group schemes, sophisticated members of the group will act as buyers for all, while communal pressures or regulatory intervention can prevent exploitation of the weak or naïve”.

This invites the question whether large provider-sponsored funds should have membership determined by the employer or the individual member (i.e. an open fund system). A danger of an open fund system is that higher earners might be tempted to contract out of the employer-sponsored default fund, which could substantially weaken Asher’s point on protection of the weak, and also could result in a situation where lower paid workers lose the benefits of potentially valuable cross-subsidies from their higher paid colleagues. There are also related concerns on risk costs. On balance, I am wary of the open fund model – it is not easily reconciled with the solidarity principle.

Of course taxation policy could also play a meaningful role in driving the desired outcomes. For example, better tax concessions for members who contribute towards solidarity than those who do not might be a way to address the concern raised in the previous paragraph. A discourse on taxation policy is beyond the scope of this paper other than to note it should be used as an additional lever to drive the desired outcomes.

The power of defaults is another example of a simple legislation change that can aid greatly in increasing replacement ratios and hence decreasing poverty in retirement. McCarthy[9] recommends the introduction of appropriate defaults to maximise preservation and ensure appropriate investment strategies. He states that behavioural finance work demonstrates the extremely powerful effect of defaults, and even that “financial education and incentives are typically much poorer at changing individual behaviour than defaults”.

That is not to state that a multi-pronged approach to reduce costs should not be considered.

Industry agreed expense disclosures have been successfully introduced in the unit trust industry, and further work on how to attain similar levels of disclosure in the wider retirement funds industry is recommended. It is recognized that the many different ways to levy charges makes such disclosure no easy task e.g. administration fees stated as a Rand per member per month or as a percentage of payroll, investment management performance fees, fixed per fund costs such as audit fees, etc.

But I do believe there is scope for significant innovation in this area. For example, one off-the-wall idea would be to compel all charges (including administration fees, consulting fees and investment management fees) to be levied as a flat percentage of assets under management which would have the dual advantage of facilitating easy market comparisons, and entrenching further what could be regarded as desirable cross-subsidies between the rich and the poor. There could, however, be disadvantages to such an idea (e.g. over time weakening the relationship between fees earned and cost / value of work performed) - my main point being that much innovation is possible on the subject of fees and disclosure rather than a specific recommendation.

The challenge of how to increase competition was already identified by the Taylor Commission in its 2002 report.

[9] Presentation to the 2008 Sanlam Employee Benefits Benchmark Symposium.

In my view, this is the crux of the matter – effective competition in an environment underpinned by consumer education and awareness will result in cost reduction. In fact, I would suggest that this trend is already very much in play in the retirement fund industry with consumer awareness significantly better than it was a decade ago.

The financial press has certainly played a meaningful role here.

One could ask the question why we have concerns about the existing levels of competition when there are so many different competitors within the industry (e.g. asset managers, administrators, etc.)? I think the answer is simply that the level of *effective* competition cannot simply be measured by the number of players in the market. One also must consider the relative strengths of these competitors. I suggest that currently the market balance is wrong – there are too many weak competitors and too few strong competitors, a problem exacerbated more in some areas of the market than in others.

Rusconi examines the question of the ideal number of market participants in an accredited opt-out environment in his 2007 research published by the DoSD[10] to which the reader is referred for a more complete discussion. As an example, Chile has evolved from twelve providers when the new individual accounts system commenced in 1981 to six providers. Intuitively I feel the right answer is somewhere close to the Chilean experience (perhaps with closer to twelve than six strong competitors).

The Taylor Commission recommended that "the regulating bodies be required to perform a regular review of competition within these markets and investigate ways of increasing competition". I am not certain to what extent this recommendation was acted upon, but I most certainly endorse it.

One could argue that from a macro level, reducing charges to the consumer implies a combination of the following possibilities:

1. Reducing returns on capital to industry players.
2. Eliminating industry inefficiencies (including unnecessary regulatory "red tape").
3. Reducing cost structures within industry players.

I would argue that 1 above is problematic except to the extent that pockets of abnormally high returns on capital might possibly be eliminated - shareholders can always choose to invest in other industries or indeed other countries.

Industry consolidation is probably required to achieve cost savings 2 and 3 above. It is simply a matter of economies of scale. Unfortunately a sobering thought is that since the majority of costs of most industry players (investment managers and administrators) are staff-related, it would seem that the end game must be lower overall levels of employment in the retirement industry (possibly combined with lower pay in some specific quarters). This in turn will demand increased levels of automation, and hence benefit structure simplification (e.g. the elimination of manual processes and exceptions, fewer investment options, etc.).

The role of intermediaries (aka consultants) requires particularly close scrutiny. I would argue their role is a particularly vital one if we want to create a culture of effective competition.

Rusconi argues "In the institutional space, however, savings levels are less likely to change and marketing is more about attracting another provider's customer than about motivating additional savings".

Such arguments emanate from the premise that intermediaries do not add value to consumers - an assertion that I would challenge. My view is that there are both good and bad intermediaries, and we need to find a model where market forces will push in the direction of forcing intermediaries to continually "up their game". There are many good intermediaries who not only fight for the rights of their clients, but also serve as an effective means to ensure that product providers are continually aware of the need to provide quality service in an increasingly competitive environment.

[10] *South Africa's Mandatory Defined Contribution Retirement Savings System : Provider Accreditation*

On this point, a discussion on the regulated commission scales is in order. The current regulated scales are as follows:

- 7,5% of the first R142 000 contributions per year; plus 5,0% of the next R103 000 contributions per year; plus 3,0% of the next R284 000 contributions per year; plus 2,0% of the next R1 021 000 contributions per year; plus 1,0% of the remainder of contributions.

In my view there are two very different but logical business models to charge fees:

1. the professional fee-for-service hourly paid model.
2. fees related to value added.

The regulated commission scales, except by coincidence, bear no relation to actual work performed or value added.

I therefore suggest they are unsustainable.

Proponents of maintaining the regulated commission scales would argue that the free market might increase costs. They might point to the reality that although the regulated commission scales are only maxima, in general these are the actual fees charged. My counterargument would be that this reflects the way products are structured and positioned in the market, together with poor consumer knowledge of their rights combined with a lack of effective competition.

I would argue we adopt a free market approach for all but the smallest funds (where there could be legitimate concerns about consumer knowledge). Asher's point of the strong protecting the weak in group purchase decisions is particularly powerful.

In an environment of unregulated commission scales, intermediaries would be forced to demonstrate their true value add to consumers. This would include demonstrating their degree of independence from product providers. Certainly the market we would end up with is very different to what it looks today – I would argue we would end up with a better more efficient market, with fewer but more effective intermediaries each forced to continually focus on delivery to their clients.

The important point is that we need to find ways to increase consumer awareness of their rights and all the costs that are paid, and to break down the information gap that exists between consumers and providers.

This is, of course, not so easy to achieve in practice. Nonetheless I would suggest it would be better to make this the continual focus of our efforts rather than to try restructuring the entire retirement funds industry. As long as progress is slow and steady, we will get closer to the ideal over time without assuming any significant transition risks or costs.

**Key Dummy Takeaways:**

- ***It's better to start taking tangible practical steps towards our goals today than spending years on theoretical debates.***
- ***As one would expect, Rusconi's analysis reveals that the existing South African institutional retirement fund sector provides better value than competing business models such as retirement annuities and unit trusts.***
- ***Group schemes offer inherent advantages because the strong protect the weak and naïve.***
- ***Costs are important (although there are also other important factors in evaluating different value propositions).***
- ***A practical step is to set a cost saving target, and work towards achievement of this goal over time.***
- ***Optimal usage of the power of defaults is a relatively quick and easy way to encourage preservation and other desired behaviours.***
- ***Market forces can be used to decrease costs provided we create an environment where effective competition can flourish.***
- ***Significant consolidation is necessary to achieve the desired cost savings.***

## 5. WHO IS THE REAL DUMMY?

*"I have a cunning plan."*
*Baldrick, fictional character and squire to Edmund Blackadder*

*"The threat is stronger than the execution."*
*Aron Nimzowitsch, Chess Grandmaster, 1933*

In this paper I have attempted to argue in fairly simple terms that a first principles approach to retirement fund reform can yield significant dividends over time. Let's take small pragmatic steps towards the end goal.

In fact, I believe that the glacier is already moving, and cannot be stopped. Compare where we are today to where we were a decade ago in terms of consumer education and awareness. Market forces are compelling reform at various touch-points.

Sometimes I wonder if this entire retirement fund reform debate is a ruse. The conspiracy theorist in me has the thought that maybe someone within Government realised this years ago, and put forward the more radical National Social Security System (NSSS) proposals simply to drive the market to accelerate trends such as consolidation and cost reduction. There is significant anecdotal evidence that simply publishing the NSSS proposals has had this desired effect. If indeed so, that hidden hand deserves a lot of credit – he / she ain't no dummy!

**ACKNOWLEDGEMENTS**

Thanks to Anthony Asher, Elias Masilela and Rob Rusconi for their useful comments and suggestions – their capacity for hard work, independent thinking and adherence to principle is an inspiration.

## REFERENCES


1. Asher, Prof. A : *The Design of Retirement Schemes : Possibilities and Imperatives*, Thesis submitted to the Faculty of Science, University of the Witwatersrand, 2007

2. Asher, Prof. A : *Weaving the Social Fabric*

3. Financial Planning Institute : *Social Security & Retirement Fund Reform in South Africa*, November 2007

4. Frye, Isobel : *Poverty, Social Security and Civil Society in South Africa*, published by Brot fur die Welt, December 2008

5. Government, COSATU, FEDUSA and NACTU : *Joint Press Statement*, 27 June 2008

6. Inter-Departmental Task Team, *Outline of a Social Security and Retirement Savings Framework, Discussion Document*, 29 November 2007

7. Masilela E, *Social Security and Retirement Reform Information Sheet*, published by Sanlam Employee Benefits, April 2008

8. Masilela E and Kaniki S : *South Africans Contributing towards a Pension : Evidence from the Labour Force Survey*, January 2009

9. National Treasury : *Retirement Fund Reform - a discussion paper*, December 2004

10. National Treasury : *Social Security and Retirement Fund Reform, Questions & Answers*, 21 February 2007

11. National Treasury : *Social Security and Retirement Fund Reform, Second Discussion Paper*, February 2007

12. National Treasury : *2009 Budget Review, Chapter 6 Social Security*, March 2009

13. Pinera, J : *Empowering Workers : The Privatisation of Social Security in Chile*, 1996

14. Presentation by John Anderson, *Social Security and Retirement Fund Reform*, Actuarial Society Seminar, August 2007

15. Presentation by Colin Southey and Howard Buck, *Impact on Retirement Funds*, Actuarial Society Seminar, August 2007

16. Presentation by Colin Bullen, *Retirement Fund and Social Security Reform*, Actuarial Society Seminar, August 2007

17. Presentation by Elias Masilela, *Is there enough fuel for the Journey?*, Sanlam Employee Benefits Benchmark Symposium, 2008

18. Presentation by David McCarthy, *An Evaluation of the NSSS Proposal*, Sanlam Employee Benefits Benchmark Symposium, 2008

19. Presentation by Andrew Donaldson, *Social Security and Retirement Reform*, Actuarial Society Seminar, September 2008

20. Presentation by David O'Brien, *Benefit Design – Don't Leave the Poor Behind*, Actuarial Society Seminar, September 2008

21. Presentation by Rowan Burger, *DB or not DB*, Actuarial Society Seminar, September 2008

22. Presentation by Simon Hendrie, *Benefit Design – Low Income Perspectives*, Actuarial Society Seminar, September 2008

23. Registrar of Pension Funds, *47th Annual Report*, 2005

24. Rusconi, RD : *Saving for Retirement in South Africa : Charges to the Consumer*, South African Actuarial Journal, Volume 5 2005

25. Rusconi, RD : *South African Institutional Investments – Whose Money is it Anyway?*, January 2008

26. Rusconi, RD : *South Africa's Old Age System : Evaluating Design Alternatives*, published by Department of Social Development, September 2007

27. Rusconi, RD : *South Africa's Mandatory Defined Contribution Retirement Saving System : Provider Accreditation*, published by Department of Social Development, September 2007

28. Samson, Prof. Michael : *An Options Assessment with respect to making the Social Old Age Pension Universal*, published by Department of Social Development, September 2007

29. Statistics South Africa *: Income & Expenditure of Households 2005/2006*

30. Taylor Commission Report, Chapter 9 *Retirement and Insurance*, 2002