FINANCE COMMITTEE PORTFOLIO
21 June 2006
HEARINGS ON 'BULKING' IN THE INSURANCE INDUSTRY

Chairperson: Mr Nene (ANC)

Documents handed out:
Alexander Forbes submission
Glenrand M.I.B. Presentation on 'bulking.'
Glenrand MIB submission
Old Mutual submission
NBC Holdings submission
Advantage submission
Federation of Unions of South Africa (FEDUSA) submission
Congress of South African Trade Unions (COSATU) submission
M Cubed Employees submission: Part one and two

SUMMARY
Alexander Forbes admitted that there had been instances of non-disclosure. The company had apologised to its clients for the non-disclosure and had co-operated fully with the Financial Services Board, including providing a very detailed report.

After consultations with the Financial Services Board, Alexander Forbes had agreed to make a settlement of R380 million to its clients. The process had already begun and would put the clients in the position they would have been in had the cash management interest rate been applied to their funds. A sub-committee of the board was established to further revamp systems and business practices and ensure that there would be full disclosure in the future.

Glenrand M.I.B. said that it did not utilise imprest accounts for the payment of benefits and no longer charged commission on the outsourcing of annuities and had not done so for several years. A potential outsource exercise that they had been busy with for the past six months had always been on a non-commission basis. It had commenced with a revision to its client servicing and costing model. This included a move towards earning income strictly by way of explicit fees agreed on with clients and doing away with other forms of remuneration such as commission.

Old Mutual said that that the one area where there was not enough emphasis was that trustees had to consent fully to the bulking process. The key issues were whether the administrator retained any portion and whether this was disclosed and agreed to by the trustees. All four Old Mutual administrators passed on all the money received from bulking. They charged no additional fees attached to the service as there was one administration cost and their internal review showed that its two largest administrators were sound in all respects.

NBC Holdings said that the company was set up in 1998 and for the first two years Alexander Forbes had held a minority stake until April 2001. No income was received by NBC during the time its client funds participated in the Alexander Forbes cash management group. However,

when NBC established its own cash management group they had incorrectly omitted to advise their clients that they would retain a small portion of the improved interest as a fee.

They were of the view however that the taking of secret profits could be remedied by the consent of the principal. In this regard they had issued a general disclosure to the trustees of all of their client funds and had commenced a process of formally dealing with the issue directly with the trustees of the funds at properly constituted trustee board meetings.

Advantage said that there was no possibility of bulking occurring with Advantage as each client had their own account which was administered separately. However, there was the possibility of a conflict of interest where investors put money in their account and there were delays in when the money was utilised. Subsequent to their submission to the Financial Services Board, there was an issue with scrip-lending income however. They were required to disclose and gain consent for "off-balance sheet" clients as they acted as agents. Where they administered "on-balance sheet" accounts, they had made disclosures to the life or unit trust companies but they did not disclose to the end clients, or trustees of the funds.

They had genuinely believed that that they had been acting within the ambit of the law but based on their discussions with the Financial Services Board, they had started a process of discussing their commercial arrangements with their clients to find out if they were satisfied. This was not enough however. Disclosure needed to be made, consent was required and fee sharing arrangements needed to be finalised.

The Federation of Unions of South Africa said that financial sector service providers were placed in a position of trust towards retirement funds and as such were under a legal duty to act in the best interest of their clients at all times. Receiving secret profits or undisclosed compensation from other parties was not acceptable practice. FEDUSA would welcome the Financial Services Board directive to pension fund trustees, setting out the minimum requirements for the disclosure of bulking for it to be illegal. Retirement fund trustees must not be rushed into signing quick settlements with bulking defaulters.

Trustee training was probably the fundamental issue underlying many of the problems being exposed in the retirement industry today. If the retirement fund trustees were not trained properly, it was questionable whether they would be able to ask the right questions and to spot things that might go wrong before it was too late.

The Congress of South African Trade Unions said that they rejected suggestions that if an administrator had paid a few million Rands to the Financial Services Board for trustee training, it could escape the might of the law. COSATU was very concerned that a signal from the industry was that you can steal from the poor as much as you can and when you are caught, pay back what you have stolen and the matter was closed.

COSATU said that a Commission of Enquiry needed to be established by the Minister of Finance to investigate all other irregular practices in the financial services industry, especially retirement funds. It planned to embark on a national wide campaign to name and shame those administrators who secretly profited from bulking and ask its members to instruct their fund trustees to move their funds to administrators who were not involved in such activities.

The Financial Services Board said that all the companies that had made submissions had the wrong idea and interpretation of the disclosure requirement. True disclosure was telling the trustees in clear terms that their assets were to be bulked with others. There had to be an indication of the enhancement in the interest rate, disclosure of what proportion they would retain and clear calculations of all the amounts.

Some companies would not comply so action would be taken against them. National Treasury would also have to examine if some of the administrators were fit to hold public funds and the

withdrawal of licences might follow. The agreement with Alexander Forbes to repay the R380 million did not bind the individual funds it administered so they could institute legal action against Alexander Forbes if they wished.

The Pension Fund Registrar added that in the short-term they were going to approach the Committee with recommendations to amend the Pension Funds Act and its Regulations. In the long-term, there would be a total review of the Pension Fund industry with continuing emphasis on education for trustees.

The National Treasury said that the retirement industry was critical as it dealt with the nation's savings. Companies therefore had to be held to the highest level of accountability. The days of opaque fees and conflicts of interest were "a thing of the past". Treasury was concerned that some administrators had deliberately blocked and delayed the process of information collection. They operated under licence, so if they wanted to keep them they had to co-operate fully with the Financial Services Board.

MINUTES

Alexander Forbes submission

Mr P Moyo, the Group Chief Executive (Elect), said that it important that it operated with the utmost of integrity and wanted to lead the industry in terms of disclosure and transparency issues. They estimated that the practice of bulking had started ten years ago and had stopped in September 2004.

Over this period, their clients earned about R1 billion which they would not have made if the accounts had stood alone. They did admit that there had been some instances of non-disclosure and that was the single biggest issue here. The company had apologised to its clients for the non-disclosure and had co-operated fully with the Financial Services Board (FSB) including providing a very detailed report.

After consultations with the FSB, Alexander Forbes had agreed to make a settlement to its clients of R380 million. The process had already begun and would put the clients in the position they would have been in had the cash management interest rate been applied to their funds. A sub-committee of the board had been established to further revamp their systems and business practices and ensure that there would be full disclosure in the future.

The preliminary review of their past practices showed other instances where full disclosure was not made or there were concerns that there was no disclosure. The review should be completed by the end of July with the findings given to the FSB.

Discussion

Mr B Mnguni (ANC) asked how much of the bulking profits they had kept. Why did they continue making the secret profits even though they had known for four years that is was wrong?

Mr Moyo replied that they had kept about 27% of the profits. They had obtained legal opinion that stated that bulking without disclosure was illegal, but it could be rectified with full disclosure later, which is what happened. The Financial Advisory and Intermediary Services Act (FAIS) came into force in 2002 and called on all banks and financial institutions to disclose the extent of their fees. Alexander Forbes was unable to determine precisely what their fees were from day to day so they stopped the practice in 2004.

Mr I Davidson (DA) said that he was disappointed that Alexander Forbes had not explained their activities in detail and had not commented on the allegations made by Personal Finance magazine.

Mr Moyo replied that the presentation was short because bulking was not really the important issue. The real debate was around disclosure, so they confined their submission to this only.

Mr V Vezi (IFP) asked what social programmes they contributed to now. Was the money they had to repay sufficient?

Mr Moyo replied that Alexander Forbes spent about R4 – R5 billion per year on social programmes. The company and its shareholders had taken a knock because of the repayment of the R380 million but it was important to earn back the confidence of customers, so in that regard the fine was sufficient. The fine also put the customers in the position they would have been in had the practice not occurred.

Mr Moloto (ANC) asked what lessons Alexander Forbes had learned from this experience, especially about the role of their board and their audit committee in the making of the secret profits. What steps were in place now to prevent the abuses happening in the future?

Mr Moyo replied that the lesson had been a very expensive one for the firm. To stop future abuses, an independent board with authority over corporate issues had been established. The audit committee only became aware of the issues in October 2003, and the matter was attended to quickly to maintain consumer confidence.

Glenrand M.I.B. submission
Mr G Morris, the CEO, said that to increase the revenue of both retirement fund clients and Glenrand M.I.B, bank bulking of their clients' Standard Bank Accounts was implemented on the 3rd on May 2005 and Nedbank accounts on the 14th of December 2005. At all times the bank account of each client remained segregated. By agreement, Glenrand would earn 50% of the enhanced interest from the Standard Bank accounts, and 33% of the Nedbank accounts.

Of the funds currently administered by, 28 had not yet signed the service level agreement and there had been non-disclosure on only four of them. The FSB's investigation also involved a request to former senior executives to identify past practices that may have amounted to bulking as well as other sources of secret profits. One account, the CBC account, was such a bulking/imprest account. The account was still under investigation and the information would be verified by PricewaterhouseCoopers when they audited their practices.

Glenrand M.I.B did not utilise imprest accounts for the payment of benefits and no longer charged commission on the outsourcing of annuities and had not done so for several years. A potential outsource exercise that they had been busy with for the past six months had always been on a non-commission basis. Glenrand M.I.B also did not conduct securities lending of client assets. This also applied to Ten50Six Life, a relatively recent acquisition on which some of their client assets were housed in investment portfolios.

Glenrand M.I.B had commenced with a revision to its client servicing and costing model. This included a move towards earning income strictly by way of explicit fees agreed with clients and doing away with other forms of remuneration such as commission. It was the company's intention to continue with the bulking of retirement fund monies, but from the 1st of July 2006 they would cease to share in any of the additional bulking income. Fees charged in terms of their service level agreements would be inclusive of this service to clients.

Discussion
Mr Davidson asked if taking 50% was not too much.

Mr Morris replied that whether the 50% rate was too much depended on the type of fund. For small funds the 50% was not really a lot of money. Therefore, the larger funds tended to have a smaller percentage applied.

Ms M Mabe (ANC) asked that since they did not charge commission fees, were they included in other fees.

Mr Morris replied that there must be an explicit statement of all the fees with no hidden costs. This was necessary for members to know what their obligations were.

Ms J Fubbs (ANC) asked why they were going to stop sharing profits from bulking in July.

Mr Morris replied that the 1st of July was the end of their financial year so it was a convenient date.

Old Mutual submission
Mr Van Wyk said that the one area where there was not enough emphasis was that trustees had to consent fully to the bulking process. Bulking was a common and desirable process and allowed pension funds to benefit from scale. The benefit was the same no matter how large or small the account was. The end result of bulking had to be a benefit to the account. The key issues were whether the administrator retained any portion and whether this was disclosed to and agreed by the trustees.

Investment mandates usually specified the operating capital that each account had to have. At Old Mutual the current account balances were held in cash management groups for the four 'big' banks. Preferential interest rates were negotiated for all the groups and the rates were then monitored daily. As a result of this management, all of their funds received better than 'call rates' on the accounts.

All four Old Mutual administrators passed on all the money received from bulking. They charged no additional fees attached to the service as there was one administration cost and their internal review showed that its two largest administrators were sound in all respects.

Retirement fund reform was crucial to individual welfare and the economic growth of South Africa. It was also important that the confidence of the public in the retirement fund industry was not undermined.

Discussion
Mr Moloto asked how their administration costs for bulking were absorbed since they said they did not charge anything for negotiating bulking.

Mr Van Wyk replied that all their charges were put into their administration fees and this was renegotiated every year with the trustees.

Ms Fubbs asked if there was a conflict of interest created by Nedbank being part of Old Mutual.

Mr Van Wyk replied that Old Mutual and Nedbank dealt with each other at arms length and actually competed for business.

Mr Davidson asked if it was not necessary to also get input from the funds' members.

Mr Van Wyk replied that the trustees ran the funds on behalf of their members and were elected by the members. All the funds' annual statements were available to the members but perhaps the reporting arrangements could be improved.

Mr Mnguni asked if Old Mutual played a role in the education of trustees.

Mr Van Wyk replied that trustee training was important but the debate was about whether service providers should be involved in the training. At present, Old Mutual did make training available.

NBC Holdings submission
Mr M Mayisela said that the company was set up in 1998 and for the first two years Alexander

Forbes had held a minority stake until April 2001. No income was received by NBC during the time its client funds participated in the Alexander Forbes cash management group.

Cash balances held in individual funds' bank accounts were recognised by their bank (Standard Bank) as one amount together with the current account cash balances of funds administered by NBC who also operated current accounts with Standard Bank. However, when NBC established its own cash management group they incorrectly omitted to advise their clients that they would retain a small portion of the improved interest as a fee.

They were of the view however that the taking of secret profits could be remedied by the consent of the principal. In this regard they had issued a general disclosure to the trustees of all of their client funds and had commenced a process of formally dealing with the issue directly with the trustees of the funds at properly constituted trustee board meetings.

Discussion
Mr B Mnguni (ANC) asked how much of the bulking profits they kept.

Mr Mayisela replied that the quantum differed from fund to fund, that is, it depended on how much was in the fund. They were currently providing the FSB with all the information about every account they administered, but usually they kept about 10% of the profits.

Advantage submission
Mr M Mthombeni noted that there were different ways in which a client could invest in Advantage. They could either do it "off-balance sheet" where they retained ownership of the assets, or "on-balance sheet." The client was then issued with a premium in a life company or a contribution in a trust company.

There was no possibility of bulking occurring with Advantage as each client had their own account which was administered separately. However, there was the possibility of a conflict of interest where investors put money in their account and there were delays in when the money was utilised. They had made a submission to the FSB about what happened to any interest that that money had garnered.

There was some confusion about how multi-manager fees were calculated and captured. These fees could also be a source of conflict of interests. Advantage did disclose these fully to clients. A bigger 'source of pain' for clients was performance fees and the Regulator could be helpful in developing a code of practice to define these.

Subsequent to their submission to the FSB, there was an issue with scrip-lending income however. They were required to disclose and gain consent from "off-balance sheet" clients as they acted as agents. Where they administered "on-balance sheet" accounts, they had made disclosures to the life or unit trust companies but they did not disclose to the end clients, or trustees of the funds. This was because of their misinterpretation of the legal principles as they thought that ownership had been passed on.

Scrip-lending was risky as it involved the buying and selling of assets. The returns were capital growth and Advantage charged another fee for doing that buying and selling. It was necessary to minimise the risk as much as possible so an added value to Advantage was generated by charging the fee.

They had genuinely believed that that they had been acting within the ambit of the law but, based on their discussions with the FSB, they had started a process of discussing their commercial arrangements with their clients to find out if they were satisfied. They agreed that that was not enough however. Disclosure needed to be made, consent was required and fee sharing arrangements needed to be finalised.

Discussion
Mr Mnguni said that the FSB had said that some fund managers generated transaction costs to increase their profits. What was their reaction to this?

Mr Mthombeni replied that they were trying to find ways to reduce their transaction costs since they were ultimately passed onto customers. Their system analysed all of the fund managers daily to ensure that excessive costs were not manufactured.

Federation of Unions of South Africa (FEDUSA) submission
Ms G Humphries said that it had emerged that administrators were making undisclosed profits from bulking the funds under their administration and then negotiating a higher rate of interest to be paid on the funds, but taking some of this benefit for themselves without approval from the pension funds under administration. This was tantamount to taking away benefits from pension fund members without their knowledge or approval.

FEDUSA would tolerate no less than the highest standards of accountability. Financial sector service providers were placed in a position of trust towards retirement funds and as such were under a legal duty to act in the best interest of their clients at all times. Receiving secret profits or undisclosed compensation from other parties was not acceptable practice.

There may be other permutations of this practice with the net result in each instance being an improper benefit or perquisite gained by the administrator at the expense of the funds under its management, and without full disclosure being made to the funds.

Bulking was not illegal *per se* and was a good way to enhance returns and administrators who did not do this were failing in their duties. The justification that disclosure had been made to the trustees was also no defence against this breach of a fiduciary relationship.

FEDUSA would welcome the FSB directive to pension fund trustees, setting out the minimum requirements for the disclosure of bulking for it to be legal. Trustees would need to be told up front by administrators whether bulking of a particular fund would occur; how much extra interest would be earned; what the respective shares of the fund and the administrator would be; and why the activity would add to administration costs.

Trustees had to remain vigilant when bulking had taken place unlawfully, in that money was due to their members and former members. If the trustees accepted a reduction in fees, they may deprive former members of their due. Trustees could also limit their options if they wanted to change service providers, as this may result in trustees not acting in the best interest of their funds.

Retirement fund trustees had to refuse to rush into signing quick settlements with bulking defaulters. They would place themselves at risk if they did so. What trustees had to ask was: "Will I be able to justify my actions to the Pension Funds Adjudicator, knowing the adjudicator's firm stance on the fiduciary duty of trustees?"

Trustees must demand that bulking defaulters provide them with free actuarial assistance so they could make sure that every current and former fund member received the correct compensation, including interest, for bulking.

Trustee training was probably the fundamental issue underlying many of the problems being exposed in the retirement industry today. If the retirement fund trustees are not trained properly, it was questionable whether they would be able to ask the right questions and to spot matters that might go wrong before it was too late. This problem was compounded by the fact that many trustees were trained by the same companies that provided their funds with products and services.

Properly trained trustees would also have known that they should have demanded that an administrator, such as Alexander Forbes, bulk their funds' assets to get the best interest rates or discount, and that the administrator should have passed these beneficial rates and discounts on to their funds so they could provide better benefits for their members.

The good governance of their retirement funds was the basic building block of training trustees. The foundation stone for all trustee training was that trustees had to have a proper understanding of what constitutes good fund governance. This meant that trustees must understand their fiduciary duty.

FEDUSA also believed that the burning issue pertaining to bulking would be prevalent in the funds administered as Umbrella Funds.

Congress of South African Trade Unions (COSATU) submission
Mr J Mahlangu said that in regard to the administrators' fiduciary role to the funds, there is only one way by which such transactions can be validated, and that is by the free consent of the principal following upon a full disclosure by the agent. There was one rule only, that a fiduciary may not receive any benefit than the agreed remuneration, and only one exception to this: on the fully informed consent of the principal. The problem was where the administrator included its own funds to the pool of monies of the funds in order to receive the high rate of interest that the funds received.

COSATU rejected suggestions that if an administrator had paid a few million Rands to the FSB for trustee training, it could escape the might of the law. A conducive climate for the working poor to save for their retirement should be sustained and any one who secretly profited from workers' savings should face the full force of the law. COSATU was very concerned that a signal from the industry was that you can steal from the poor as much as you can and when you are caught, pay back what you have stolen and the matter is closed. They rejected suggestions that it was a costly exercise to bring criminals to book in the retirement fund industry and rejected the idea that big institutions could do as they liked since the law would not catch up with them.

That some administrators created investment companies to circumvent section 13A and B of the Pension Funds Act so that they take secret profits from retirement funds against their own internal and outside legal advice, showed the country what was at issue here. Directors of administrators who creatively benefited improperly from retirement funds should face the might of the law. COSATU continued to support the Registrar of Pension Funds for all initiatives taken to protect the interest of poor workers who sacrificed much for their families in order to save for their retirement, only to find they have instead made huge secret profits for administrators.

COSATU also said that a Commission of Enquiry needed to be established by the Minister of Finance to investigate all other irregular practices in the financial services industry in general, and the retirement funds in particular. The terms of reference of such of a commission should include an investigation of the history and background of bulking or improper benefit practices of the life and private sector fund administration companies.

The investigation should also relate to the regulation and enforcement of the monitoring and control of life and private sector fund administration companies in respect of conflict of interests in the industry, which created a conducive environment for the development of bad practices such as bulking. Also, the investigation should reveal Government's role in letting the problem develop.

COSATU was going to embark on a national wide campaign to name and shame those administrators who had secretly profited from bulking, and ask all of its members to instruct their fund trustees to move their funds to administrators who were not involved in such activities.

Discussion
Mr Mnguni said that it was hard to discover unlawful bulking. Was COSATU saying that all

trustees had to have certain qualifications? Some administrators did their own trustee training. Did COSATU see this as adequate?

Mr Mahlangu replied that there must be a debate on the role of auditors. Many of the trustees affiliated with COSATU had agreed that it was not right for service providers to give training since it ended up being exploited by the service provider who could turn it into a marketing exercise.

Ms Fubbs asked FEDUSA if the free actuarial assistance they wanted would not affect the independence of the opinions.

Ms Humphries replied that FEDUSA tried to appoint people with some accounting experience as trustees. They were in discussions with the Minister to get training programmes set up and the FSB was being consulted as well. The independence of the opinions may be affected but it was more important to get some assistance.

Financial Services Board response
Mr Dube Tshidi, Deputy CEO, said that all of the companies that had made submissions had had the wrong idea and interpretation of the disclosure requirement. Disclosing after-the-fact was not a real remedy. The questions to ask were: did the administrator make secret profits, did they act with integrity or did they act out of their own interest? True disclosure was telling the trustees in clear terms that their assets were to be bulked with others. There had to be an indication of the enhancement in the interest rate, disclosure of what proportion they would retain and clear calculations of all the amounts.

The common law said that agents had to act in good faith in the best interests of their members. Therefore, negotiating higher interests rates was part of this duty and they could not charge for doing so. Most of the submissions made to the FSB contained misinformation, so calculations were going to have to be made and money was going to have to be repaid.

Some companies would not comply so action would be taken against them. The Treasury would also have to examine if some of the administrators were fit to hold public funds and the withdrawal of licences might follow. The agreement with Alexander Forbes to repay the R380 million did not bind the individual funds it administered, so they could institute legal action against Alexander Forbes if they wished. There was also no immunity from prosecution or any other action by the FSB and investigations were still continuing. The FSB's first concern was restitution, followed by the possibility of legal action.

The FSB deputy Pension Fund Registrar, Mr Jurgen Boyd, added that in the short-term they were going to approach the Committee with recommendations to amend the Pension Funds Act and its Regulations. Some of the changes included the need to define market conduct for administrators or to create a code of conduct for them under FAIS. There would also be rules for disclosure to prevent the loose interpretations at present. The Registrar's powers would also be widened to allow him/her to apply for interdicts, to allow class actions and the power to subpoena. The issue of underwritten funds was also problematic and had to be re-examined.

In the long-term, there would be a total review of the Pension Fund industry with continuing emphasis on education for trustees.

National Treasury response
Mr Jonathan Dixon, Chief Director: Financial Sector Policy, said that the retirement industry was critical as it dealt with the nation's savings. Companies therefore had to be held to the highest level of accountability. The days of opaque fees and conflicts of interest were "a thing of the past." Work was underway to redress the issue of conflicts of interest in the life and retirement sectors.

The Treasury and the FSB were also discussing possible amendments to redress the abuse of

bulking. Treasury was concerned that some administrators had deliberately blocked and delayed the process of information collection. They operated under licence, so if they wanted to keep them they had to co-operate fully with the FSB. Licences could be taken away for refusing to comply, delaying the process or failing to disgorge undue profits. It must also be clear that there was full, not partial redress, so it was worrying that some of the administrators were trying to negotiate payments.

The meeting was adjourned.
