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TOPIC: MANAGING AND ASSESSING SERVICE PROVIDERS IN PENSION PROVISION

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INTRODUCTION

Good governance of retirement funds is a major focus for most economies of the world as the safeguarding of retirement fund assets is an important part of every economy and that retirement funds continue to be the primary source of income for many people across the world. Trustees bear full responsibility and accountability of the management of retirement funds. It is therefore important that trustees should collectively have the necessary skills and knowledge to manage all the functions of the fund and be in a position to assess and manage the performance of those to whom they have delegated their responsibilities (service providers).

Service providers function as intermediaries in the pension value chain. They are a conduit to deliver pension benefits to pensioners from the moment money is deducted from member's salaries and employers to recording contributions, investments, actuarial valuations, issuing of periodic member benefit statements, calculation of various retirement options, death benefits as well as administering the payment of retirement benefits.

It is common cause that in the absence of the necessary skills trustees may delegate their duties to service providers[1]. These may include auditors, actuaries, fund administrators, investment managers, pension consultants, custodians etc. It is important to carefully ascertain when trustees can actually procure service providers and what it means to solicit service providers. If trustees do not understand or do not convincingly display the expected knowledge of trusteeship they are placed in a position of trust and fiduciary to solicit skill elsewhere.

Whilst trustees bear the full responsibility and are legally accountable for managing the affairs of a retirement fund, our observation from a regulatory point of view is that trustees tend to abdicate their fiduciary duties to service providers, and in turn service providers use this opportunity to maximise their profits for services rendered to the uninformed trustees. This can be through the fees they charge or for increasing the scope of work, which may not be necessary. It goes without saying that service providers run profitable entities and as such it is clear to note that their interests are maximising profits.

In an industry where trustees are uncertain of their fiduciary responsibilities and service providers are seeking to maximise their profits, how do we manage and assess service providers in pension provision? We believe that the deteriorating ethical standards and a value system is fraught with fraud, corruption, nepotism and self – serving interests.

SCOPE OF THE PRESENTATION

This presentation encompasses:

- The assessment of service providers and their management;

[1]OECD Guideline for pension fund governance, June 2009

- The circumstances under which service providers can be procured;
- The duties of trustees when assessing and appraising the performance of service providers and
- The impact of the use of service providers on retirement benefits.

The author will use Investment Consultants as a major case study in assessing how the use of service providers may impact on retirement benefits. Impact can be negative and positive. Negative impact could be as a result of poor investment decisions made by the service provider on behalf of funds and the quantum of professional fees charged to funds for services rendered. Positive impact could be that the use of service providers has enhanced the ultimate retirement package, reduced risk and enhanced returns. For purposes of this presentation the author will deal with only the negative impact of the use of service providers.

It will also highlight the areas that contribute to a negative impact on retirement benefits. The author will discuss mainly the issue of “one-stop-shops” and delegation of duties. The author acknowledges that there are different forms of pension schemes but for purposes of this presentation has elected to discuss private occupational schemes. Private occupational schemes are most often created by an employer. Most of Swaziland’s registered pension schemes are occupational schemes and I have therefore omitted reference to negotiated funds. Contribution levels are pre-determined by the employer and the scheme is privately managed.

PURPOSE

Trustees often do not have the necessary skills or resources to manage all aspects of pension provision hence the need for delegation of some of their duties to experts. This paper will allude therefore to the circumstances under which trustees can delegate responsibilities to service providers. It will also endeavour to answer the following questions:

- Why is it necessary to assess service providers in pension provision?
- Who should assess service providers?
- What is the role of the regulator?
- How should service providers be supervised?
- What is the procedure for procuring service providers?

THE TRUSTEE FIDUCIARY DUTIES

Serving in a board of trustees can be the most challenging job. It involves certain responsibilities that require certain level of competency and skill. It is the duty of the trustees to ensure that a fund has rules in place, assets are invested properly, records kept and that the fund complies with regulatory requirements.

The governing body of the pension fund should be subject to a prudent person standard such that the investment of the fund’s assets is undertaken with care, skill, prudence and due diligence[2]. Under the prudent person standard, the pension fund's trustees are given broad authority to invest the pension assets in a prudent fashion in light of the particular needs of the fund[3]. The standard is that a prudent person undertakes his or her obligations with the skills and knowledge that an expert would bring to the required tasks. The trustee fiduciary duty requires that trustees act in the best interest of the members and beneficiaries in matters regarding the investment of pension assets and to exercise due diligence in the investment process.

Trustees who fail to perform their fiduciary duties satisfactory may be personally liable to make good any loss suffered by the fund as a result of their failure. Assessing and appointing a service provider is one of the fiduciary duties. Trustees may hire a service provider to handle some of the function which form part of their fiduciary duties. This may include:

- The investment of fund assets;
- Fund administration and
- Custodial duties.

However, delegation does not absolve them of their fiduciary duties and their responsibility to the members of the fund.

SELECTING A SERVICE PROVIDER

Selecting a competent service provider is an important responsibility of trustees. The criteria for selecting a service provider are as follows:

- Trustees must first consider what services are needed by the fund. In most jurisdictions services like auditors, actuaries and administrators are required by law as part of the regulatory process. Trustees need to carry out a prudential assessment of the service providers bearing in mind their fiduciary responsibilities to the fund. They must ensure that the service providers selected are fit and proper and that they have a proven track record of the service they provide.
- They must ensure that the fees charged are commensurate with the service provided.
- They must ensure that the service providers are licensed and are in good standing with regard to regulatory requirements.
- They must ascertain whether there are any complaints pending against the service provider.
- They should assess if there is any material conflict of interest.

One of the most important factors to consider when selecting a service provider is the fees charged. Trustees should consider the fees involved before deciding on any service provider[4]. Fees are usually charged as a percentage of the fund assets and most jurisdictions do not provide a guide on the level of fees that need to be charged for certain services provided to

[2] OECD Principles of Occupational Pension Regulation 2010
[3] *supra*
[4] U.S Department of Labour paper on Selecting and Monitoring Service Providers

the fund. In this case trustees need to shop around for better fees without compromising quality and member's interests.

ASSESSING SERVICE PROVIDERS

Assessing service providers involves reviewing the structures and processes for appropriate checks and balances[5]. It is crucial for trustees to consider *inter alia* the following issues; good faith, skill, prudence and due diligence[6]. Trustees need to be aware of potential service provider conflict of interests. In addition, they need to investigate the best solution for the fund at a cost that is reasonable for the work provided, and then to monitor this solution against a benchmark that has been constructed in line with the fund's promise to the members on their investments. However, this is with the understanding that trustees are educated enough to understand what they shop for. The challenge comes when trustees do not have the skill to know what a good service provider is.

Although the duty to assess service providers lies first with the trustees as they are the ones held in trust of the assets of the fund, the regulator has an equally daunting task in assessing the service providers as it has the duty to license these service providers[7]. The regulator forms part of the governance structure of a retirement fund[8] as trustees are not allowed to contract with service providers without its approval.

Trustees must periodically review the performance of service providers to determine if their services still add value to the fund. This may be done based on the service level agreement signed between the parties. They must also evaluate[9]:

- If the service provider adheres to the terms and conditions of the agreement;
- The materiality of reports provided;
- The reasonableness of fees charged
- If the service provider is still in compliance with regulatory requirements
- If the service provider maintains the necessary insurance requirements e.g., the fidelity guarantee cover, professional indemnity ;
- If there aren't any complaints pending against the service provider and
- If the service provider still meets the required standard.

MANAGING SERVICE PROVIDERS

The relationship between the fund and service providers would normally be managed by service level agreements[10]. Service level agreements should stipulate the terms of the agreement in a clear and an unambiguous way. Trustees should empower so that they can be

[5] King Code of Governance Principles For South Africa, 2009
[6] Section 66 (6) Retirement Funds Act no.5 of 2005
[7] Section 66 (7) of the Retirement Funds Act no.5 of 2005
[8] OECD Guideline for Pension Fund Governance, June 2009
[9] U.S Department of Labour paper on Selecting and Monitoring Service Providers
[10] *supra*

in a position to question practises or terms that may seem unfavourable in terms of the agreement put forward for the services rendered by the service providers. Service level agreements should stipulate the time investment criterion as well as the fees involved[11].

Trustees should ensure that the investment manager understands the investment mandate in terms of trustees should also ensure that the assets of the fund are invested in suitable investment portfolios or asset classes. They should also be able to monitor and agree on clear terms on how much will be paid as fees. It is important that trustees understand what they are being charged for and that they should only pay for actual work done. It can, however, be tricky at face value for trustee to understand how the fee structures are implemented for financial services. There are percentage fees, retention fees, performance, accrued fees etc. the trustees should always ask that a list of the actual work to performed is provided, and the method of calculations should be included.

Another option is that the fund requests its service providers to invoice them directly and not take fees at source. The norm would be that the investment manager can pay for his services indirectly – by deducting his payment from investment returns generated on behalf of the fund. The actual fees paid are then transparent to trustees. The regulator believes it is preferable for trustees to see what they are paying for.

There is also the issue of the “one-stop-shop”. These all inclusive services are said to minimise costs and it is convenient to get all services related to a fund at one place. But, this comprises compromises the objectivity that trustees should have when dealing with their service providers. Trustees should refrain from relying exclusively on one source of information in order to avoid conflict of interest[12]. Multiple service providers would also introduce a level of cross-checking. The problem with one stop shops is that it defeats the whole purpose of checks and balances hence it shifts from an issue of getting the best possible service to convenience.

In procuring service providers trustees need to adhere to best practises. The following are some of the best practises: trustees ought to[13]:

- Adopt a code of conduct;
- Formulate an Investment Policy Statement (IPS) that is balanced for risk and return;
- Implement a performance assessment tool for trustees which should inform their education, pricing and training policy;
- Evaluate risks associated with all existing and proposed outsourcing arrangements[14];
- Develop a process for determining the materiality of arrangements[15];
- Implement a program for managing and monitoring risks commensurate with the materiality of the arrangement[16];

[11] Mhtml:file://H:/Understanding Retirement Plan Fees and Expenses.mht
[12] OECD Guideline for Pension Fund Governance, June 2009
[13] U.S Department of Labour paper on Selecting and Monitoring Service Providers
[14] Office of the Superintendent of Financial Institutions Canada - Guideline on Outsourcing of Business Activities, Functions and Processes 2009.
[15] Supra

The overall cost of running a fund is an important factor to consider in the appointment of service providers, as this has a direct influence on the actual benefit due to the members. However, trustees should not compromise on the quality of service and advice that is available to them based on fees alone. They should consider the long term benefit as well. The following points inform the best solution for the trustees in fulfilling their fiduciary obligations:

- Formulate a detailed Investment Policy Statement (IPS) that is balanced for risk and return;
- The IPS should include the investment objective (vision) as well as the investment strategy (goals and objectives);
- The investment strategy will detail the asset allocation and the types of mandates (which will effectively articulate the specific services the fund require from service providers) for the fund to reach its investment objective;
- The IPS should outline the investment mandates and benchmarks per investment portfolio and the overall fund and most importantly the cost likely to be incurred in the execution of these investment portfolios;
- The IPS should detail the roles and responsibilities of the service providers.

The IPS is essentially a living document that the trustees should refer to in monitoring the overall investment strategy of the fund to ensure that the investment objectives set out in the formulation of the IPS continue to be of relevance to the needs of the members[17].

The IPS document should guide the trustees in exercising their fiduciary responsibilities by documenting the decisions taken by the fund to enhance and preserve the retirement benefits. There is evidence in the IPS of why strategies were implemented, what information was used and how the decision was implemented. This demonstrates that due process was followed and that trustees have acted in members' interests.

The above demonstrates how risk based assessment of the fund and the services it requires can be made by minimising the exposure to inappropriate service providers (in the event that they have obtained the necessary approval from the regulatory authorities). The author has been directly involved from a regulatory perspective in assisting trustees understand how their role/decisions they take on behalf of the fund has an impact on the final retirement benefit the member is able to cash in upon retirement.

Having come full circle by agreeing that the regulator sets the framework where retirement funds operate in, the regulator registers and approves pension schemes and the rules of the fund, the regulator approves the service providers who will in turn offer these services to the trustees in aid of fulfilling their fiduciary responsibilities. However the lack of a code of conduct, transparency and monitoring tools, the fund finds itself in a disadvantage situation. Upon a close look, this could be attributed to a combination of the following issues:

[16] Supra
[17] OECD Guideline for Pension Fund Governance, June 2009

- The lack of the necessary education on the trustees to enable them to comprehend the basic principles of the financial markets; or
- The lack or ineffective use of a code of conduct to guide the trustees in upholding a high level of ethical standards (avoidance of accepting bribes from potential service providers in lieu of management capabilities) results in them being less vigilant in carrying out their duties in managing the fund's assets; or
- That the service providers' moral obligations have deteriorated to a point that they can manipulate information in order to generate more income under the watchful eye of unsuspecting trustees etc.

REGULATION OF SERVICE PROVIDERS

There is poor regulation of service providers. Most often service providers belong to a certain professional body or association and such bodies do not specifically regulate their relationships with their diverse clients. They do however generally have ethical standards but such could be disregarded. The author has done an assessment of why service providers are able to conceal for instance certain fees and found that the bigger picture is poor financial literacy. Financial education may very well be available but the lack of incentives compromises the quality of the work of trustees and exposes them to accepting kickbacks. It has been mentioned earlier on that risk is passed to the person who least understands it. This means that if trustees do not understand an income statement for instance they may find themselves attracting personal liability as a result of poor investment decision or misappropriation of funds by service providers. In fact the Swaziland Retirement Funds Act no.5 of 2005 states that trustees may be held accountable in their personal capacities for financial loss pension funds may suffer in the event they do not fully discharge their fiduciary duties.

It is without doubt that service providers are needed and that they are professionals who have the technical know-how. They are however susceptible to cutting corners especially where they know they are dealing with people who do not fully understand and if such will help them achieve their ultimate goal which is maximum profit then they may not always resist.

CONCLUSION

The issue of trustee education could very well be over-emphasised but to what extent will education assist trustees in effectively supervising service providers. Education enlightens trustees but leaves them with so many burdens because they realise the onerous duty that is placed upon them.

It was mentioned earlier on that the paper will specifically concentrate on private occupational schemes. In private occupational schemes trustees are in formal employment and they have a duty towards the employer as employees. It is without doubt that the duty of trustees is an onerous one as much as the duty towards the employer is. Perhaps it is time we revisit the whole process of electing trustees amongst members (employees), seeing that the persons endowed with so much power are also torn between meeting expectations of their employer, it is perhaps time to consider increasing reliance on independent trustees.

One may ask if it is fair on the employer who established a retirement scheme for its employees to have its business suffer because of underperforming employees as a result of their onerous duty as trustees. Besides retaining staff and helping employees achieve a secure financial future[18] what good does having a retirement fund has on employers especially those in profit making industries. It is for that reason that trustees are sometimes not willing to have meetings because they are concentrating on their work for the employer.

It is all well and good that the retirement funds industry has evolved since the 17th century to date and in light of the demands of regulation and moral decay in society, it is perhaps time we change how retirement funds are managed. It is perhaps time for retirement funds to run independently from the employer. It is true funds are separate legal entities[19] but their independence is compromised by trustees who double as employees. Independent trustees can be hired and paid for by the fund and if such proves expensive employers should consider joining under umbrella funds. This is not to say umbrella funds are not susceptible to manipulation but the burden is transferred from the trustees to experts who understand the dealings of service providers and expectations from regulators. By extension pension supervisors will be offloaded the duty to ensure trustee training and will channel all its energies to a more effective and vigilant supervision of the pension industry.

If trustees cannot understand or manage expenses, if they can't trust service providers and if service providers can't control themselves then it is perhaps time to retire retirement funds.

[18]Mhtml:file://H:/Understanding Retirement Plan Fees and Expenses.mht
[19] Section 5(7) of the Retirement Funds Act, no.5 of 2005