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Taking a cue from corporates on how to safeguard and future-fit our retirement funds

It has been a while since the King IV Report on Corporate Governance for South Africa (King IV)™[1] was published in 2016. It was the first of the King reports to include a bespoke supplement for retirement funds, emphasising the role retirement funds can play in the overall corporate governance ecosystem and the creation of value.

The recent South African Reserve Bank report on the characteristics of the South African retirement fund industry reinforced the importance of private retirement funds in the financial market. These funds can enable household wealth and is therefore critical in ensuring a well-functioning system. South Africa's retirement fund industry holds assets of more than R4.6 trillion[2], also comprising a material portion of the JSE Limited.

There are several building blocks necessary for ensuring a well-functioning system, many of which focus on the critical role of retirement fund boards of trustees as fiduciaries and stewards.

In trying to look beyond the obvious building blocks like the investment component, it is educational to ponder factors that could lead to a system or retirement fund no longer functioning well or not being sustainable.

In its 2004 paper on retirement reform, the National Treasury (NT paper) suggested that although retirement fund failures do not occur often, when they do, the consequences can be disastrous. It suggested that regardless of the cause, in almost all instances there is an underlying failure to exercise appropriate and sufficiently rigorous standards of fund governance.

As the NT paper suggested, there are not many examples of catastrophic fund failures. The Financial Sector Conduct Authority (FSCA) has since 2017 appointed statutory managers on funds in only four instances.
However, aiming to avoid catastrophic failure should not be the primary hurdle. There is an enormous range between catastrophic failure or curatorship on the one side and best-in-class or “a gold standard” on the other.

Let's consider the example of the Private Security Sector Provident Fund (PSSPF): The PSSPF was investigated due to allegations of corruption and maladministration in their processes. During the investigation wrongdoings were found which resulted in further checks into the board of trustees, as well as service providers for the PSSPF.

It was found that the board of trustees had chosen service providers with higher membership prices and poor industry experience when there were companies with lower costs and more experience. The appointment of the service provider was signed in a closed bid process with no evidence of analysis of comparison of other competing companies and no written explanation for this closed bid.

According to Moonstone, after an investigation into the PSSPF which lasted three years, the FSCA concluded that the trustees:

- Failed to take all reasonable steps to ensure that the interests of members, in terms of section 7C of the Pension Funds Act 24 of 1956 (PFA), were always protected.
- Failed in their fiduciary duty of acting with due care, diligence and in good faith, by not ensuring the procurement of service providers was done in a cost effective manner.
- Failed to ensure that the resources of the PSSPF were used in a sound and cost effective manner, which was a breach of the board's duties in terms of the PFA and the Financial Institutions (Protection of Funds) Act 28 of 2001[3].

[1] Copyright and trademarks are owned by the Institute of Directors in Southern Africa NPC and all of its rights are reserved
[2] The Retirement Funding in South Africa 2022 report
[3] https://www.moonstone.co.za/fsca-takes-action-against-private-security-sector-provident-fund-trustees/ accessed on 4 April 2023

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This example, albeit not catastrophic, is similar in tone to many of the highly publicised and televised corporate failures, suggesting most causes relate to fraud, non-compliance, or financial mismanagement.

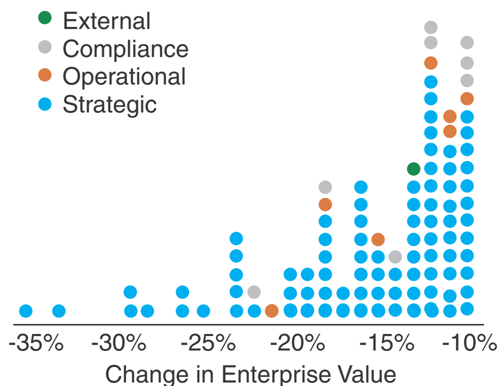
It's difficult to assess how effectively retirement funds have been in embracing the best practices articulated in King IV in support of a well-functioning financial ecosystem. Arguably, the only lens applied by most retirement funds in applying King IV has been that of responsible investing, fuelled by regulations such as Regulation 28 of the Pension Funds Act that requires appropriate consideration of any factor that may materially affect sustainable long-term performance of the fund's assets. Relevant factors include those of an environmental, social and governance (ESG) character. The Code for Responsible Investing (I and II) has a similar focus on responsible investing: non-negotiable of course, but not exclusionary of the broader concepts and requirements.

It may well be timely to perform a factual assessment of the level of application of King IV in retirement funds to inform the next evolution of fund governance in response to an exponentially changing world. So yes, in learning from these types of failures (both corporate and retirement fund examples), we recognise that a well governed, compliant and responsible retirement fund is the ticket to the game. Your VIP access stamp is arguably your application of the King IV principles, CRISA and other best practices.

Exhibit: **Why they fail**

Strategic blunders result in the greatest loss of shareholder value.

Distribution of Bottom Performers by reason for failure



Source: Booz & Company

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But other than catastrophic or fairly large-scale failures, what could failure look like on a continuum and what may be causing these failures? Considering the lack of retirement fund-focused research on this topic, it is instructive to consider corporate failures.

A study by Booz and Company (now PwC Strategy&) analysed 2 500 companies assessing the causes for the 17% identified as having failed over the prior decade[4] with failure in this analysis defined as lagging the industry by more than 20%.

Contrary to what we see in the catastrophic failure space, in this case the research found that more than 80% of the failures were in fact the result of strategic blunders, rather than large-scale fraud or mismanagement.

External factors included declines resulting from shocks that were natural, political, or regulatory in circumstances where the external event could not be controlled or easily anticipated.

Compliance included fraud, accounting issues, ethics violations, and other failures to comply with laws or standards.

Operational included major operational problems, such as supply chain disruptions, customer service breakdowns, and operational accidents.

Strategic included major strategic blunders or a company caught by a major industry shift, including failed M&A, as well as dramatic shifts in major enterprise value drivers.

[4] *2012, Booz & Company, "Why Companies fail"*

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What could be viewed as potential strategic blunders in the context of a retirement fund?

- Not being aware of megatrends driving global change, like climate change, the impact of technology, artificial intelligence and ever-increasing life expectancy
- Linked to megatrends and future predictions and implications on strategy, one of the top three reasons businesses will fail over the next 10 years, according to Forbes, is not prioritising sustainability[5]
- Not adequately understanding and adapting to the impacts of new ways and styles of working and a gig economy
- Underestimating increased disclosure expectations from members, including reporting on impact and the risk associated with inadequate reporting
- Not recognising and responding to an evolution in generational values resulting in changes in member expectations and needs over time
- Inadequate consideration of transformation imperatives, including Broad-Based Black Economic Empowerment objectives and requirements
- Not embracing, defining and giving heed to the board of trustees' social purpose[6]

We know that regulation always lags change and transformation, but it is likely that in the medium term, some of the items reflected as potential strategic blunders could easily transform into governance and compliance failures as several are likely to be more explicitly incorporated into our regulatory frameworks.

South Africa was one of the first countries to require ESG factors to be taken into consideration by retirement fund trustees in their investment decisions. However, within the broad language of Regulation 28 there is significant room for varied interpretation and application and several global developments have since leapfrogged.

Some international regulatory requirements and developments

In the United Kingdom the Pension Schemes Act 2021 already requires schemes to adopt and report against the Taskforce on Climate-related Financial Disclosures (TCFD) recommendations.

In Australia a series of highly influential legal opinions from the Australian Centre for Policy Development, subsequently referenced with approval by all of Australia's major financial regulators, point to the fact that consideration of material climate risks falls within the fiduciary duty of trustees of superannuation funds. They need to exercise their powers and discharge their duties with a degree of reasonable care and diligence. Climate change risks should be assessed as a financial risk.

Despite there being no express legislative requirements for disclosure, in the McVeigh v Retail Employees Superannuation Pty Ltd [2019] FCA 14, the Australian Federal Court ruled in favour of Mr McVeigh, a retiree who claimed that his superannuation fund had failed to adequately disclose the climate change risks associated with its investments. The court found that the Retail Employees Superannuation Trust had breached its fiduciary duties by failing to provide Mr McVeigh with material information about the climate-related risks facing his investments. This decision is seen as a significant precedent for other cases seeking to hold superannuation funds accountable for their handling and disclosure of climate change risks.

The Dutch Pensions Act of 7 December 2006 requires the management report (which forms part of a fund's annual report) to explain how their investment policy takes account of climate change, human rights and social relations. The International Socially Responsible Investment Covenant for Pension Funds (IMVB Covenant), a sector covenant on identifying, prioritising, and addressing ESG risks, requires participating pension funds to draw up their ESG policy as soon as possible after 1 January 2019 and ultimately before 30 June 2021. Although the IMVB is not legally binding and participation is voluntary, more than 80 Dutch pension funds, which together account for around 90% of the total assets managed by Dutch pension funds, have signed the IMVB Covenant.

As a trustee, are you well equipped and positioned to future-proof the retirement fund you serve: not only against failures, but by proactively ensuring it is resilient and able to sustain an uncertain and exponentially changing future?

Your retirement fund's future is not yet determined – it's in your hands. Can you handle it?

[5] The top 10 reasons why businesses will fail over the next 10 years, Bernard Marr, 29 August 2022
[6] the NT paper, in referencing the board of trustees' duties, emphasised that: "The board undertakes functions which fulfil both a financial and social purpose."