

# The process of ethical decision-making in South African retirement funds

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## ABSTRACT

As the principal decision-makers in retirement funds, trustees have a number of duties placed upon them including a duty of care, a duty of impartiality, a duty to avoid and manage conflicts of interest, a duty to act in accordance with the purpose of the fund and a duty of accountability. Decision-making by trustees and the actuaries that assist them can be informed by considering various ethical theories. This paper reviews the theory of right action, virtue theory and the ethics of care, together with the theory of justice, and interprets the duties of trustees and actuaries in terms of these theories. After consideration of other frameworks for ethical decision-making, a six-step decision-making framework based on the actuarial control cycle is developed to provide an initial attempt to formalise the process of ethical decision-making in South African retirement funds. This framework is applied to case studies involving the review of surplus apportionment, an investment policy statement, the distribution of death benefits, and annuitisation options. The case studies illustrate that, although the framework itself does not provide ethical solutions, it assists trustees, and the actuaries who advise them, with the process of making an ethical decision.

## KEYWORDS

Ethics; ethical framework; retirement fund; trustees; actuaries; fiduciary duties; regulation; theory of right action; utilitarianism; virtue ethics; ethics of care; theory of common good; theory of justice

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*As we practice resolving dilemmas we find ethics to be less a goal than a pathway, less a destination than a trip, less an inoculation than a process.*

—Rushworth Moulton Kidder

## 1. INTRODUCTION

1.1 The aim of this research paper is to explore how the somewhat abstract and broad concept of ethics can be applied in the day-to-day process of decision-making in South African retirement funds.

1.2 This research paper is aimed at trustees, as the primary decision-makers in retirement funds, and the actuaries who support them in their decision-making. The principles, however, may be applied to other stakeholders such as sponsoring employers.

1.3 Trustees of retirement funds have certain duties placed upon them in terms of common law and in terms of an array of legislation (Hanekom, 2013; Downie, 2010). These duties include a duty of care, a duty of impartiality, a duty to avoid and manage conflicts of interest (Hanekom, op. cit.) and a duty to act in accordance with the purpose of the fund (Watchman, 2011; Du Toit, 2002; Hanekom, op. cit.; Downie, op. cit.). In addition, trustees have a duty of accountability in terms of which they may be held accountable for their actions and for all decisions made (Downie, op. cit.).

1.4 Trustees may be assisted by actuaries. Members of the Actuarial Society of South Africa (ASSA) are held to a Code of Professional Conduct that emphasises that the services that actuaries render to their clients, including retirement funds, must reflect ethical conduct.<sup>1</sup> The Code requires of members honesty, integrity, competence and due care, and that the actuary's behaviour should reflect and uphold the profession's duty to the public.<sup>2</sup> Thus, actuaries providing advice to retirement fund trustees should consider not only the duties faced by their clients but those placed on them by the actuarial profession.

1.5 This research paper explores these duties by addressing the following questions:

- To what extent does the discharge of duties placed on trustees and actuaries of retirement funds lead to ethical issues?
- Can an ethical decision-making framework assist trustees and actuaries with the process of ethical decision-making?

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1 Actuarial Society of South Africa, Code of Professional Conduct, 2012. [www.actuarialsociety.org.za/Portals/2/Documents/CodeOfProfessionalConduct-2012.pdf](http://www.actuarialsociety.org.za/Portals/2/Documents/CodeOfProfessionalConduct-2012.pdf), 09/07/2014

2 Ibid.

1.6 The actuarial literature is marked by a scarcity of writing focused on ethics despite Waddock (2005) noting that ethics is an essential part of education for business professionals and Lowther, McMillan & Venter's (2009) survey suggesting that it is ethical values that are important for actuarial quality. Asher (1998) considered decisions relating to ethical investing. Asher (2001) considered decisions relating to retirement fund surpluses, but this was carried out with the goal of developing generic criteria for justice in the context of specific problems to be resolved rather than developing a general framework for decision-making. Although Lowther (2004) considered the professional duties involved in the exercise of actuarial discretion when calculating transfer values for retirement funds, this was considered primarily in the context of the application of actuarial techniques in a field with existing professional guidance. Lowther & McMillan (2006) state that ethics apply in situations where required codes of conduct and guidance have not been specified. This paper thus represents an initial attempt to formalise the process of ethical decision-making for general application in South African actuarial pensions practice.

1.7 The aim of this paper is not to provide trustees and actuaries with in-depth analysis of ethical theory. There is a vast amount of literature on ethical theory and the authors can best be described as interested amateurs. The goal is to provide a formal and theoretically sound framework that trustees and actuaries can adopt to promote a more ethical process of decision-making which the authors argue is essential in the discharge of trustee and actuarial duties.

1.8 In order to show the practical application of the framework for ethical decision-making, the authors have selected four case studies based on their personal experience and selected Pension Fund Adjudicator (PFA) cases. Since the specific circumstances have been adapted in some cases, references to specific funds and cases have been omitted. These case studies are used for illustrative purposes and cover a variety of ethical issues. The first case study covers the distribution of surplus on pension funds, which is an historic issue that provides an opportunity for retrospective analysis. The second case study concerns the determination of investment strategy, an ethical issue that practitioners faced at the time of writing. The third case study is based on the distribution of death benefits. This is a non-traditional area of actuarial involvement in pension funds. It thus represents an emerging field in which ethical dilemmas arise. The fourth and final case study deals with annuitisation proposals made as part of retirement reform proposals. As these proposals have not yet been finalised, this represents a future area in which decisions will need to be made in an ethical manner. It is important to note that this paper does not focus on whether the final decision reached in each case was ethically sound but rather on the process of ethical decision-making. Indeed, it is possible for two individuals to reach different conclusions using the same decision-making framework (Kidder, 1995).

1.9 Establishing whether the discharge of the duties faced by trustees and actuaries leads to ethical issues requires an understanding of what is meant by the term 'ethics'. This is set out in Section 2. As the emphasis of this paper is on a framework for an ethical decision-

making process, the literature review is brief and focuses only on the elements of ethical theory required to appreciate that the discharge of all trustee and actuarial duties leads to ethical issues and to develop a framework for ethical decision-making to be used by trustees and actuaries. In Section 3, the duties of trustees and actuaries are revisited and mapped to the concepts introduced in Section 2. Section 4 sets out general frameworks for ethical decision-making, while Section 5 sets out the authors' framework for application in retirement funds. Sections 6 to 9 provide case studies illustrating the practical application of the framework provided in Section 5. Section 10 closes with a summary and conclusion.

## **2. LITERATURE REVIEW**

### **2.1 Overview**

2.1.1 Normative ethics deals with distinguishing right from wrong (Copp, 2006). Where decision-makers recognise that there are decisions that are clearly right and those that are clearly wrong, the desired course of action should be to choose right over wrong (Kidder, *op. cit.*). Kidder (*op. cit.*) considers the more interesting ethical dilemmas to be those where there is a right-versus-right choice, where decisions involve weighing up two competing ideals that both appeal to the decision-maker. These include the tension between individual and community, short-term and long-term, justice and mercy, and truth and loyalty.

2.1.2 The choice between the individual and community is concerned with the extent to which the right of an individual or small group can be elevated over the rights of a larger group (Kidder, *op. cit.*). This sort of dilemma can arise in a retirement fund context when trustees are considering a decision that may suit most of the members but would have a particularly poor outcome for a small group of members.

2.1.3 The extent to which long-term needs are prioritised over short-term goals is another right-versus-right dilemma (Kidder, *op. cit.*). In a retirement fund, this may be a significant consideration when considering an element of fund design relating to the withdrawal benefit. Although it may be in the member's long-term interests to preserve their retirement savings on exit, their short-term need may be to feed their family and this might require taking the benefit in cash.

2.1.4 Justice, which is impartial, is often in conflict with mercy, which takes all relevant factors into account (Kidder, *op. cit.*). This conflict may arise, for example, in a fund which provides pensions directly from the fund. Adverse experience may result in a very low increase being affordable. Some of the pensions might be very low. Justice would require the trustees to follow their pension increase policy even if this meant very low pensions for some members. Mercy would motivate for larger increases, particularly for vulnerable pensioners.

2.1.5 Truth and loyalty may be in conflict (Kidder, *op. cit.*). This might arise in a retirement fund when trustees consider themselves loyal to the group that elected or appointed them. The employer or members may have certain distinct objectives and trustees may feel that being impartial and speaking the truth about what is best for the fund as a whole may be considered disloyal to their constituency.

2.1.6 A number of ethical theories can assist with these distinctions. This section reviews just three major theories: the theory of right action, virtue theory and the ethics

of care. These theories are then discussed in the context of the theory of justice. In other frameworks, such as those set out in Section 4, it is recognised that there is a large body of literature on ethical theories. Only a subset of this body is used in the development of the decision-making framework due to the specific purposes that these theories are intended to serve. The theories used to develop the framework in this paper were selected as they had, in the opinion of the authors, the closest correspondence with decision-making of trustees and actuaries. The motivation for this reasoning is set out in Section 3. In addition, they correspond closely with the right-versus-right dilemmas set out by Kidder (*op. cit.*). The intention of this review is not to provide a comprehensive exposition of these theories but, rather, to explore those elements of these theories that would assist in the understanding of the ethical nature of trustee and actuarial duties, and the development of a framework for ethical decision-making to be used by trustees and actuaries.

## 2.2 Theory of Right Action

2.2.1 A theory of right action attempts to determine the basic factors that make an action right or wrong (Copp, *op. cit.*). Of the three ethical theories reviewed, this is the only ethical theory that evaluates the action itself. This evaluation may be carried out through the lenses of consequentialist or non-consequentialist theories (*ibid.*).

2.2.2 Consequentialist theory is based on the premise that a right action is one that promotes good or one that produces the most value (Copp, *op. cit.*). In other words, a right action can be judged by its outcome. The most common example of consequentialism is utilitarianism (Brink, 2006). By the standards of utilitarianism, an action is only ethical if the sum of all the utility of one action is greater than the sum of all the utility of another action (Ferrel & Gresham, 1985). This involves consideration of the utility of all stakeholders (*ibid.*). For example, in a retirement fund, the utility of members may be a function of how much they would contribute and the benefit that they would receive. This theory is particularly helpful in resolving individual-versus-community dilemmas.

2.2.3 Non-consequentialist theory or deontology evaluates actions not on outcome but on adherence to duties (Benn, 1998). According to McNaughton & Rawling (2006), the basic features of deontology include the concepts of:

- constraints arising from a moral code;
- duties of special relationships; and
- sufficiency, in that the agents need do no more than fulfil their duties.

The exposition of the moral code underlying these duties is thus central to deontology (Deigh, 1995). The duties that arise under deontology may be governed by legislation or regulation. For this reason, deontology could be seen as a combination of morality, which encompasses the effects that the action has on both individuals and the broader community, and legal and regulatory adherence (Jones, 1991). An example of deontology in retirement funds is assessing that trustees have followed the correct procedures in the discharge of their duties. Alternatively, deontology could be thought of as helping trustees develop a moral compass that would lead them instinctively to consider certain outcomes as wrong. This

theory is helpful for assisting trustees to identify which right they prioritise in right-versus-right dilemmas.

### **2.3 Virtue Theory**

2.3.1 Annas (2006) describes virtue as the inclination to act in the right way for the right reasons. According to virtue theory, a truly virtuous person would always act ethically in that they would always do the right thing for the right reason. Thus virtue theory requires the cultivation of aspirational virtues (Benn, *op. cit.*) or character (Hursthouse, 1999). Virtue theory holds deontology as a secondary goal given that those without perfected virtues may need to rely on rules (Copp, *op. cit.*). Virtue theory involves a necessary overlap between personal and professional morality (Fleddermann, 2011).

2.3.2 Thus, while theories of right action evaluate the action itself, virtue theory evaluates the character traits behind the action, including adherence to rules. The right-versus-right dilemmas by definition involve prioritising some virtues over others and are frequently identified by virtuous individuals who are able to recognise the competing virtues (Kidder, *op. cit.*).

### **2.4 Ethics of Care**

2.4.1 The ethics of care involves the assessment of the degree to which people's needs are met (Copp, *op. cit.*). The ethics of care is based on the concept that people are relational and that these relationships, both personal and professional, should result in needs being met (Held, 2006).

2.4.2 The theory of common good is a special case of the ethics of care. Audi (1995) defines common good as the goal shared by all who advance the cause of justice in a community. Argondoña (1998) describes the common good as a set of conditions that allow members of society to achieve their personal objectives and thus advance the good of society.

2.4.3 Despite the theory of common good allowing for individuals to pursue personal objectives, the ethics of care stands in contrast to individualism which prioritises the pursuit of individual interests (Held, *op. cit.*). This is because the theory of the common good involves the promotion of justice (Audi, *op. cit.*). According to Benn (*op. cit.*), justice requires that people are treated as "ends" as opposed to "means", which emphasises a relational aspect to justice which is the foundation of the ethics of care. Thus the ethics of care has direct application to the justice-versus-mercy dilemma and the corresponding individual-versus-community dilemma.

2.4.4 It could be argued that the ethics of care is similar to consequentialist theories of right action because it considers the cumulative effect of actions in meeting needs. However, the theory of right action emphasises the evaluation of the action itself while the ethics of care suggests that the effect on the relationship would require scrutiny. Although caring is a virtue, the ethics of care is not a subset of virtue ethics because virtue ethics focus on character traits of individuals and the ethics of care focuses on caring relations (Held, *op. cit.*).

## 2.5 The Theory of Justice

2.5.1 Although there are distinct differences between the theory of right action, virtue ethics and the ethics of care, there are some similarities between them as noted in ¶2.4.4. Held (op. cit.) argues that a complete ethical framework cannot ignore justice. Thus it can be argued that the theory of justice is essential to help distinguish right from wrong, irrespective of the ethical theory applied.

2.5.2 The theory of justice emphasises fairness and equality (Held, op. cit.) as well as individual rights and balancing competing rights (Held, op. cit; Steiner, 2006; Asher, 1998). According to Asher (1998), justice is the art of finding the balance between the needs, behaviours and ideals of different individuals. Rawls's (1971) theory of justice "rates liberty highest, and then balances equality, prosperity and need by a rule that requires the interests of the worst off to be maximised" (cited in Asher, 1998: 972). Thus, considering justice assists in the individual-versus-community dilemma.

## 2.6 Summary

The theory of right action holds that an individual action can be assessed as right or wrong. The theory of justice can aid in making this distinction. Consequential theories of right action assess the outcome of an action. Deontology examines the rules and process behind the action. Virtue ethics considers primarily the motivation for any action, with the process being a secondary consideration. The ethics of care, in contrast, focuses on the relationships between the stakeholders and how their needs are met.

## 3. DUTIES FOR TRUSTEES AND ACTUARIES TO BEHAVE ETHICALLY

This section provides a closer examination of the duties placed on trustees and actuaries and interprets them in terms of the ethical theories set out in Section 2. The authors acknowledge that there are a number of different approaches to analysing the duties of actuaries and trustees. The lists of duties detailed in this section may consequently not be exhaustive.

### 3.1 The Duties of Trustees

3.1.1 As set out in ¶1.3, trustees have a duty of care, a duty of impartiality, a duty to avoid and manage conflicts of interest, a duty to act in accordance with the purpose of the fund and a duty of accountability in terms of all decisions made and in terms of these other duties. The repeated use of the term 'duty' indicates that a primarily deontological, or duty-based, framework would apply. The Pension Funds Act explicitly states that trustees have both moral and legal duties with which they must comply. Therefore the connection between the legal and moral duties calls to mind the definition of ethics given in ¶2.2.3.

3.1.2 The duty of care involves trustees discharging their duties in the utmost good faith in a prudent manner<sup>3</sup> (Hanekom, op. cit.; Downie, op. cit.; Du Toit, op. cit.).

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3 See also PF Circular 69 and the Financial Institutions (Protection of Funds) Act, Act 28 of 2001, Republic of South Africa, as amended

Case law<sup>4</sup> suggests that this means that trustees are required to show greater care in the management of trust assets than they do their own (*ibid.*) and to be diligent.<sup>5</sup> Both Watchman (*op. cit.*) and Asher (1998) describe this as acting in the best interests of all beneficiaries—which includes members. This is echoed in Section 7C of the Pension Funds Act which states that the board of trustees must “direct, control and oversee the operations of a fund in accordance with the applicable laws and the rules of the fund” and “take all reasonable steps to ensure that the interests of members in terms of the rules of the fund ... are protected at all times”.<sup>6</sup> The principle of acting in the best interests of members is also supported by case law.<sup>7</sup> However, although members are important stakeholders, trustees cannot champion the rights of members over the interests of the fund as a whole<sup>8</sup> (Marumoagae, 2012). Although Swart (unpublished) suggests that this duty can be understood in terms of virtue ethics, the process of acting in terms of the best interests of others is essentially relational and hence arguably better understood in terms of the ethics of care.

3.1.3 According to the Mouton Committee (1992, as cited in Marx & Hanekom, 2008: 111) the duty of impartiality involves all members receiving “equal and objective treatment” from the trustees. Determinations by the PFA have reinforced that treating different groups of members differently without justification would constitute unethical behaviour, which in turn results in a breach of this duty.<sup>9</sup> Impartiality itself is considered to be a virtue and is a critical component of justice (Held, *op. cit.*).

3.1.4 The duty to avoid conflicts of interest encompasses conflicts between personal interests and official duties (Du Toit, *op. cit.*) and a requirement to act independently.<sup>10</sup> It also precludes self-enrichment at the cost of the interests of the fund and beneficiaries (Du Toit, *op. cit.*). Avoiding and managing these conflicts of interest is embodied in the virtue of objectivity, referring specifically to the trustee’s ability to consider what is best for the member, independently of any interests of the trustee.

3.1.5 Watchman (*op. cit.*) and Downie (*op. cit.*) indicate that trustees must act in accordance with the purpose of the fund. The purpose of a retirement fund is indicated in the fund rules. It often takes the form of a generic statement indicating the purpose is to provide certain benefits on specified events. Alternatively, the rules may prioritise retirement benefits over other types of benefits.<sup>11</sup> This duty suggests that, when interpreting what is

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4 Sackville West v Nourse 1925 AD 516

5 Affirm Marketing PTY (Ltd) and Others v IF Umbrella Fund and Others, Pension Fund Adjudicator determination, July 2012

6 Pension Funds Act No 24 of 1956, Republic of South Africa

7 For example Lorentz v TEK Corporation Provident Fund and Others 1998 (1) SA 192 (W) and PPWAWU National Provident Fund v Chemical Energy Paper Printing Wood & Allied Workers Union(2007) 28 ILJ 2701 (W)

8 The City of Johannesburg v The South African Local Authorities Pension Fund (20045/2014) [2015] ZASCA 4 (9 March 2015)

9 Epol Provident Fund & Others v Premier Foods Provident Fund and Others, Pension Fund Adjudicator determination, September 2000

10 Pension Funds Act, *supra*

11 BW Colledge v LTA Limited Pension Fund, Pension Fund Adjudicator determination, Sept. 1999

just and fair, one should return to the purpose of the fund. Practically, trustees may have objectives for the fund that they have determined collectively. These may include investment objectives and benefit targets on retirement for new members. Some of the objectives, and the actions required to achieve them, may sometimes conflict with the stated purpose of the fund. Trustees have the authority to change the rules and the purpose of the fund (Asher, 2001). In fact, if the rules or purpose create an ethical conflict or are not in alignment with the fund objectives, it is arguably a duty of the trustees to amend the rules. One example of such a situation may be cross-subsidies arising in the charging structure in the retirement fund. Trustees may wish to amend rules that result in poorer members cross-subsidising higher-earning members. This requires consideration of what is in the best interests of the fund and what is ultimately just, and is not something that should be undertaken lightly (Asher, 1998).

3.1.6 The duty of accountability means that the trustees must be prepared to report on their decisions and reasons for making those decisions (Downie, *op. cit.*, Du Toit, *op. cit.*). Downie (*op. cit.*) emphasises that the duty of accountability is essential to upholding the duty of impartiality. Section 7D of the Pension Funds Act extends this to include communicating to members their “rights, benefits and duties”.<sup>12</sup> Again, accountability is a virtue although this duty is consistent with the ethics of care in that it emphasises the formation of a relationship with reciprocal duties.

3.1.7 In summary, trustees need to use the purpose of the fund to guide their thinking of what is just. The virtue of justice should guide their decision-making. The relationship between the trustee and fund beneficiaries should also be scrutinised in terms of rights, duties and obligations. Ultimately, trustees should develop the virtue of accountability in addition to the virtues of diligence, impartiality, objectivity and prudence. Although prudence is a virtue, it is arguable that it is closely related to the duty of care, as mentioned in ¶3.1.2. In addition to moral considerations, trustees are also required to comply with all relevant legislation and regulation.

## 3.2 The Duties of Actuaries

3.2.1 As stated in ¶1.4, actuaries providing advice to retirement fund trustees should consider not only the duties faced by their clients but those placed on them by the actuarial profession. In the case where the actuary’s client is the board of trustees, the actuary has a duty to consider the duties faced by the trustees, outlined in ¶1.3. It is important to differentiate between the role of actuaries as advisers to the trustees and the role of trustees as the decision-makers. Actuaries are also decision-makers in the sense that they determine the advice to provide, given their professional and ethical requirements.

3.2.2 Lowther, McMillan & Venter (*op. cit.*) state that the general ethical and professional requirements of actuaries encompass an ability to avoid conflicts of interest and comply with legislation and professional guidance. The requirements include the values of integrity, objectivity, confidentiality, due care, independence, scepticism, accountability, courage, reflection and a commitment to the public interest, social responsibility, ethical

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12 Act 24 of 1956, *supra*

business, whistle-blowing and ethical judgement. The current Code of Professional Conduct,<sup>13</sup> mentioned in ¶1.4, encourages a deontological approach to ethics in terms of compliance with legislation and professional guidance. However, the remaining requirements take the form of a list of virtues, suggesting that actuarial actions can be assessed by virtue ethics where there are no rules to follow.

3.2.3 Actuarial recommendations are often based on assumptions about future experience, which may not be borne out in practice. Lowther & Mort (2002) have argued that these assumptions can be tested by considering whether the actuary had acted reasonably with regard to the information available at the time. This emphasises the importance of the virtues of diligence and reflection in actuarial work. In the opinion of the authors, this reflection can be aided by a thorough peer-review process.

3.2.4 Justice is also a key ethical requirement of actuarial work, and this goes beyond the traditional requirement of impartiality. As discussed in ¶3.1.6, accountability through disclosure is essential to impartiality which, in turn, is necessary for justice, as outlined in ¶3.1.3. The PFA has supported this logic and has emphasised the importance of justice being seen to be done by various stakeholders (Lowther & Mort, *op. cit.*). The Academy of Actuaries' standard of actuarial practice on general disclosure requirements, ASOP 41,<sup>14</sup> places the duty of disclosure firmly in the actuarial domain for actuaries providing recommendations and supporting decision-making. It also notes that a balance needs to be struck between the preservation of confidentiality, a key virtue, and the adequacy of disclosure and accessibility of information to the affected stakeholders, in order for justice to be achieved. ASOP 41 thus emphasises the importance of the virtue of accountability, in terms of disclosure, to achieve justice.

3.2.5 In summary, actuaries advising trustees need to consider the duties of the trustees, comply with relevant legislation and professional guidance, and encompass the virtues given in ¶3.2.2.

## 4. EXAMPLES OF ETHICAL-DECISION-MAKING FRAMEWORKS

A number of authors have attempted to create frameworks to assist decision-makers with ethical dilemmas.

### 4.1. The Nine Checkpoints

4.1.1 Kidder (*op. cit.*) proposes a nine-point checklist for considering an ethical dilemma.

4.1.2 The first checkpoint is to recognise that there is a moral issue. The second checkpoint involves assessing whether the person is “morally obligated and empowered” to act. In many cases, this would be true for trustees but not necessarily true for actuaries, who may simply be advisers. The third checkpoint is to gather the relevant facts.

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13 Actuarial Society of South Africa, 2012, *supra*

14 Actuarial Standards Board, Actuarial Standard of Practice 41, 2010. [www.actuarialstandardsboard.org/asops.asp](http://www.actuarialstandardsboard.org/asops.asp), 28/09/2014

4.1.3 The fourth checkpoint is to check for right-versus-wrong conflicts using the following tests:

- The legal test is the first hurdle. Where the law has not been broken, three further tests may help to clarify whether an action is ethical or not. These tests are based on the major ethical approaches considered by Kidder (op. cit.) which include utilitarianism, deontology and the ethics of care.
  - The first further test is whether the proposed action gives rise to a negative instinctive reaction. This emanates from the moral core underlying deontology.
  - The second test is whether the consequences emanating from the action are desirable. This includes the consequences for the decision-maker of the decision becoming public knowledge. This is consequentialist thinking, specifically utilitarianism.
  - The third test is whether another person, regarded as inherently moral and caring by the decision-maker, would take the same course of action. Although Kidder (op. cit.) refers to this as care-based, there is also a clear link to virtue ethics.

4.1.4 The fifth checkpoint involves testing for right-versus-right issues. As discussed in ¶2.1.1, this can involve considering the balance between individual and community, short-term and long-term, justice and mercy, and truth and loyalty.

4.1.5 The sixth checkpoint involves applying ethical theories, which in Kidder's (op.cit.) case involves deontology, utilitarianism and the ethics of care.

4.1.6 The seventh checkpoint involves assessing for compromises. These compromises are particularly important when considering right-versus-right dilemmas. The eighth and ninth checkpoints involve making the decision, and revisiting and reflecting on the decision respectively.

## 4.2 Potter Boxes

Potter (unpublished) developed a framework for analysing inputs into any ethical decision and found that they could be categorised into four types: factual, loyalties, traditional moral philosophies and grounding of meaning. These directly corresponded to Parson's theory of action which found that these elements formed an essential cycle that is required by all life, from simple organisms to societies at large (Potter, 1999).

## 4.3 The Four-Component Model

Rest (1986, cited by Jones, op. cit.) proposed a four-component model which involves the steps of recognising moral issues, resolving to prioritise ethical considerations in decision-making, evaluating options based on ethical principles, and implementing moral action. The definition of 'moral' used by Jones (op. cit.) is given in ¶2.2.3.

## 5. A FRAMEWORK FOR ETHICAL DECISION-MAKING IN RETIREMENT FUNDS

Although ethical principles remain unchanged regardless of context (Kidder, op. cit.), the decision-making process in retirement funds is subject to a variety of duties that are

specific to retirement funds, as explained in Section 3. The authors decided to use the familiar actuarial control cycle to include:

- the legal and regulatory environment, which is part of Kidder’s (op. cit.) fourth checkpoint;
- the duties of trustees and actuaries described in ¶3.1 and ¶3.2 respectively; and
- the feedback loop of monitoring the consequences of the solution and taking this into account in future decision-making. This feedback loop was incorporated due to its importance in learning and development (Bellis, 2006) and it is Kidder’s (op. cit.) ninth checkpoint.

The use of the actuarial control cycle in the context of ethics aims to make the framework more accessible to actuaries. The full framework follows in sections 5.1 to 5.6.

### **5.1. Specify the Problem: Recognise the Ethical Issue**

Kidder (op. cit.) and Jones (op. cit.) state that, in order to begin the ethical decision-making process, one needs to recognise that an ethical issue is present. The definitions of an ethical decision used by Kidder (op. cit.) and Jones (op. cit.) are given in ¶2.1.1 and ¶2.2.3 respectively. As demonstrated in Section 3, ethical issues arise whenever trustees and actuaries discharge their duties in relation to retirement funds as decision-makers and advisors respectively. Trustees should identify at the outset which of the four right-versus-right dilemmas are involved as per Kidder (op.cit.). There may be more than one dilemma at play. Jones (op. cit.) also suggests including an assessment of the intensity of the ethical issue, for example, the magnitude of the consequences for affected stakeholders, and that this would determine the rigour with which the framework would be applied. At this stage, the trustees should begin to consider whether they have the ability to manage these ethical issues and whether additional assistance is required (Jones, op. cit.). This may include actuarial advice, which would require the actuary to consider the duties placed on the trustees.

### **5.2 Develop the Solution: Gather Information**

Gathering facts are key steps in the models proposed by both Potter (unpublished) and Kidder (op. cit.). The virtue of diligence means that trustees must apply their minds to all relevant facts.<sup>15</sup> Downie (op. cit.) refers to this as “the duty to know”. Young & Annisette (2009) state that individuals will not always agree on the material facts of a given situation and suggest that rather than being permanent and easily identifiable, facts are constantly changing and are subject to reinterpretation. This suggests that, for decision-making to be effective, information should be gathered and agreed upon. This process would include identifying stakeholders and all alternative courses of action (Frederick, 1999). Actuaries advising trustees are required to gather information to support their recommendations.

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<sup>15</sup> Segal and Others v Lifestyle Retirement Annuity Fund, Pension Fund Adjudicator determination, May 1999

### 5.3 Understand the Environment: Consult Legislation, Guidance and Regulation

It is arguable that a thorough understanding of the legal and regulatory environments is an extension of the requirement to establish facts. However, Jones's (op. cit.) definition of deontology explicitly necessitates an understanding of the law and regulation. In addition Kidder (op. cit.) applies a specific legal test. Given that trustees have a duty to perform certain functions in terms of the Pension Funds Act and that actuaries may have a prescribed role under the same act, an understanding of the legislative environment, including case law, is essential in a deontological framework. PF130<sup>16</sup> requires trustees and actuaries to act in accordance with relevant laws and codes of conduct when dealing with the affairs of retirement funds.<sup>17</sup> This forms part of Downie's duty to know (op. cit.). However, it is important to recognise that the values and ethical principles, which are addressed in ¶5.4, are needed because not all circumstances relating to the duties of trustees may be defined within a legal framework. In this case, adherence to the law is a necessary but not sufficient condition for ethical decision-making. There may well be cases where adhering to the law may seem to contradict what would otherwise be considered ethical. In such cases, trustees may need to consider what steps could be taken to amend unjust laws, and a just process should be followed (Asher, 1998). Actuaries are required to comply with relevant legislation, regulation and professional guidance, and similar issues may arise.

### 5.4 Develop the Solution: Evaluate Possible Options

5.4.1 Evaluation of options is a critical component of the model proposed by Rest (op. cit., cited by Jones, op.cit.) and Kidder's (op. cit.) checkpoint 3. The entire purpose of the Potter Box model is to give decision-makers a structured way to evaluate options from different perspectives (Potter, 1999). In addition to the evaluation of all tabled options, Kidder (op. cit.) encourages decision-makers also to consider compromise solutions that may not be part of the original solution set.

5.4.2 Frederick (op. cit.) states that in the process of making an ethical decision one needs to establish all material alternative actions. This may be impractical where there may be infinitely many solutions available. A shortlist may, in such cases, need to be assessed against a number of tests to see that the trustees are performing their duties. The tests proposed here follow from Section 3.1.

5.4.3 The first test is whether the option complies with the law or regulation, which is part of Kidder's (op. cit.) process.

5.4.4 The second test is to consider the purpose of the fund, as defined in the fund rules. Case law may aid in the interpretation of the rules. This is a test necessitated by the duty on trustees to act in accordance with the purpose of the fund.

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16 Financial Services Board, Circular PF NO. 130: Good Governance of Retirement Fund; Annexe B, 2007. [www.fsb.co.za/Departments/retirementFund/Circulars/PF%20Circular%20130.pdf](http://www.fsb.co.za/Departments/retirementFund/Circulars/PF%20Circular%20130.pdf), 06/08/2014

17 Financial Services Board, Circular PF NO. 130: Good Governance of Retirement Funds, 2007. [www.fsb.co.za/Departments/retirementFund/Circulars/PF%20Circular%20130.pdf](http://www.fsb.co.za/Departments/retirementFund/Circulars/PF%20Circular%20130.pdf), 06/08/2014

5.4.5 The third test is to consider what would be just. The definition of justice would involve consideration of the needs of various stakeholders, which obviously requires an understanding of who the stakeholders are (Frederick, *op. cit.*) and who the most vulnerable stakeholders are. The need to consider justice, especially when weighed against mercy, corresponds to Kidder's (*op. cit.*) sixth checkpoint.

5.4.6 The fourth test considers the obligations placed on the trustee and the actuary in terms of their relationship with various stakeholders. The specifics of the relationship would need to be considered and would be deemed to include the public interest element of professional standards for actuaries. This test corresponds to Potter's (unpublished) loyalty paradigm as well as the loyalty-versus-truth tension from Kidder (*op. cit.*).

5.4.7 The fifth test is whether the decision-makers encompass the right virtues. For trustees, this implies diligence, impartiality, objectivity and prudence. For actuaries, additional requirements include integrity, confidentiality, scepticism, courage, reflection and a commitment to the public interest among others, as discussed in ¶3.2.2. This test arises directly from the extensive duties placed on trustees and actuaries.

## 5.5 Develop the Solution: Make a Decision

Thereafter a decision should be made, as per Kidder (*op. cit.*), actioned as per Rest (*op. cit.*, as cited by Jones, *op. cit.*) and communicated. This may involve deciding on a solution that was not originally considered but which is inherently better, or at least an appropriate compromise (Kidder, *op. cit.*). In a retirement fund, the rules often state the decision-making process that must be followed and the deadlock-breaking mechanism to use if a decision cannot be made using the normal procedures. It is often incumbent on the Principal Officer of the fund, who may not be a trustee, to action the decision. Trustees and actuaries have a duty to be accountable, which means being able to justify the decision and communicate it where necessary. As noted in ¶3.2, the actuary has a professional requirement to ensure that recommendations and results are communicated in an accessible way and with sufficient detail with regard to, among others, assumptions and risk. The ethical implications of the communication would need to be considered in light of the third, fourth and fifth tests, (¶¶5.5.1–5.5.3). The specific questions that the trustees would need to ask may depend on the circumstances.

### 5.5.1 TEST 3: JUSTICE

Not all members may have access to the same communication channels. Trustees need to consider whether this would result in certain members having access to the information at different times. This may be unjust if having access to the information for longer confers an advantage to the member. If multiple communication media are used, trustees would need to ensure that all forms of communication convey the same information and give equal emphasis to the same aspects. A further consideration is that when idioms and images are used, they are frequently more meaningful to certain cultural groups than others. If this changes the meaning of the communication for some groups relative to others, that may be unjust. As mentioned in ¶3.2.4, actuaries may also assist in balancing the preservation of confidentiality, and the adequacy of disclosure and accessibility of information to the affected stakeholders.

### 5.5.2 TEST 4: RELATIONSHIPS AND CARE

The trustees would need to ensure that they use language that the beneficiary understands and have allowed the beneficiary the opportunity to query aspects of the communication that they do not understand. This is non-trivial in cases where the beneficiary is not a fund member and there is no existing relationship between the beneficiary and the fund.

### 5.5.3 TEST 5: VIRTUES

The virtues, particularly diligence, scepticism and courage, tend to encourage full disclosure, which includes alternative solutions and compromises that were considered and discarded. This may make communication longer and more complicated and may possibly be in conflict with the fourth test, as described in ¶5.4.6. This conflict may need to be specifically acknowledged.

## 5.6 Monitor the Solution: Future Decision-Making

5.6.1 It is essential that the ethical framework be expanded to include monitoring. Young & Annette (op. cit.) state that ethical behaviour is a process that requires continuing reflection on decisions and the consequences of these decisions. In other words, the decision needs to be reviewed at a later stage to assess if the correct decision had been taken and if the decision-making framework could be improved. This is important for decisions with an ongoing effect on a retirement fund, where it may not be obvious that failing to review the decision is not simply avoiding an ethical dilemma but choosing a possibly unethical course of action.

5.6.2 A review of a decision after the fact may indicate that an alternative course of action had been appropriate, even though the decision had been made using all facts at hand at the time. Jones (op. cit.) also notes the importance of the feedback loop in providing additional information for future decision-making in the organisational context.

5.6.3 Monitoring and evaluating the experience is an important component of the actuarial control cycle (Bellis, op. cit.). This includes the requirement to consider whether the actuarial solution requires modification as a result of analysis of experience. It is also explicit in Kidder's (op. cit.) checklist and in Potter's (unpublished) model.

## 6. CASE STUDY 1: DISTRIBUTION OF SECTION 15B SURPLUS

The conversion of retirement funds from defined benefit (DB) to defined contribution (DC) arrangements resulted in actuarial surplus crystallising in a number of instances (Andrew, 2004). In addition, historical practices in DB retirement funds may have resulted in former members not receiving their full actuarial value when they exited the funds, which also resulted in surplus arising (Davis & Kendal, 2012). In order to resolve these issues, the Pension Funds Second Amendment Act<sup>18</sup> (PFSAA) came into effect on 7 December 2001 (Davis & Kendal, op. cit.). These amendments came at a time when the actuarial profession was regarded with distrust by trade unions due to issues relating to the conversion to DC

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18 Act No. 39 of 2001 as amended

funds. The PFSAA represented the proverbial second chance for the actuarial profession to demonstrate integrity (Andrew, *op. cit.*). This case study considers the actions taken by trustees and actuaries in light of the proposed framework.

## **6.1 Specify the Problem: Recognise the Ethical Issue**

6.1.1 The PFSAA set out a process for actuaries to determine and distribute surplus. It required actuaries to determine the surplus available for distribution on the statutory valuation date falling between 7 December 2001 and 6 December 2004. The date of this valuation was termed the surplus apportionment date (SAD). Once the surplus at the SAD had been determined, the actuary had to recommend a scheme for the surplus to be distributed between stakeholders, including former members, current members, pensioners and the employer. The implication of the PFSAA was that actuarial discretion could alter the outcome of the process in at least three ways:

- the setting of valuation assumptions for DB funds;
- the determination of contingency reserves; and
- the apportionment of any balance of surplus once the minimum benefit obligations had been met.

The outcome had financial implications for former members, current members, pensioners and the employer at SAD as well as future generations of members. The exercise of actuarial discretion thus had ethical implications.

6.1.2 The process called for the consideration of rights of various groups of various sizes and with possibly competing interests. It was thus conceivable that individual-versus-community issues might have arisen. In addition, there were a number of stakeholders who were represented among the decision-makers including member-elected trustees, employer-appointed trustees and a former member representative. Truth-versus-loyalty issues were thus possible. Due to the fact that trustees had some discretion as to the distribution of any residual surplus, it was possible that justice-versus-mercy considerations could have applied in deciding to whom any residual should be distributed. The short-term objective of the process was to distribute the historical surplus as quickly and fairly as possible. However, there were long-term implications for the solvency of the funds if too much surplus was distributed or unsustainable precedents were created.

## **6.2 Develop the Solution: Gather Information**

Apart from the standard member, statistical and economic data required for the regular statutory actuarial valuation, extensive historical data on former members and pensioners were required in order to ascertain a fair distribution of any identified surplus as at the SAD.

## **6.3 Understand the Environment: Consult Legislation, Regulation and Guidance**

6.3.1 Regulation and guidance were produced to assist both in the determination of the surplus at the SAD and in its distribution.

6.3.2 Circular PF117<sup>19</sup> set out standards relating to the setting of assumptions and the determination of contingency reserve accounts. New regulations regarding the statutory minimum benefit for former members were set out in Board Notice 35.<sup>20</sup> These minimum benefits formed the first call on any available surplus. PGN205, now renamed APN205,<sup>21</sup> offered professional guidance to actuaries on the implementation of PF117, which required the use of a best-estimate basis with contingency reserve accounts being used to provide the required degree of prudence. This was a departure from previous actuarial methodologies that favoured a prudent basis (Davis & Kendal, op. cit.).

6.3.3 Trustees were required to apply their minds to allocating the balance of the surplus (Marx & Hanekom, op.cit.). The guidance issued by the FSB<sup>22</sup> suggested that reference should be made to the financial history of the fund in making the allocation (Marx & Hanekom, op.cit.). The tests prescribed by legislation and regulation could be summarised as:

- at least 75% of the trustees had to approve the distribution plan and confirm that the proper processes had been followed;
- the former member representative had to consent to the plan; and
- the actuary was required to certify compliance with legislation and that “the exercise of such discretion was not unreasonable taking into account the demands of equity within the bounds of practicality and the circumstances of the particular fund.”<sup>23</sup>

## 6.4 Develop the Solution: Evaluate Possible Options

6.4.1 The first major decision was the determination of the basis and the contingency reserves in order to evaluate the surplus available at the SAD. The next step was to establish the list of eligible stakeholders and then consider which of these stakeholders was to be included in the distribution of residual surplus. The process was completed with a distribution plan that allocated the surplus among these stakeholders.

6.4.2 The first ethical test is whether the process complied with the law or regulation. In this case the actuary and trustees had to certify that this was the case (as per PF114 and PF117).

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19 Financial Services Board, Circular PF No. 117: Valuation at the surplus apportionment date to determine the amount to be apportioned between stakeholders, the establishment of contingency reserve account and changes of method of assumptions, 2004. [www.fsb.co.za/Departments/retirementFund/Pages/Circulars.aspx#](http://www.fsb.co.za/Departments/retirementFund/Pages/Circulars.aspx#), 18/02/2015

20 Board Notice 35 of 2003: Assumptions to be used in determination in terms of section 14B(2)(a)(i)(bb) of the Pension Funds Act, 1956, of minimum individual reserve payable to a member of a defined benefit category of a pension fund, *Government Gazette* No. 24809, 25/04/ 2003, 18/02/2015

21 Actuarial Society of South Africa, Pension Funds Second Amendment Act, 2001, [www.actuarialsociety.org.za/Portals/2/Documents/APN205-SecondAmendmentAct.pdf](http://www.actuarialsociety.org.za/Portals/2/Documents/APN205-SecondAmendmentAct.pdf)

22 Financial Services Board, Circular PF No. 121: General guidance on surplus schemes, 2005. [www.fsb.co.za/Departments/retirementFund/Pages/Circulars.aspx#](http://www.fsb.co.za/Departments/retirementFund/Pages/Circulars.aspx#), 18/02/2015

23 Financial Services Board, Circular PF No. 114: Information required on submission of surplus apportionment scheme, 2004. [www.fsb.co.za/Departments/retirementFund/Pages/Circulars.aspx#](http://www.fsb.co.za/Departments/retirementFund/Pages/Circulars.aspx#), 18/02/2015

6.4.3 The second test is to consider the purpose of the fund in the context of PFSA. The typical purpose of the fund is to provide retirement benefits in accordance with the rules, and in the case of a DB fund the employer stands surety for these benefits. The difficulty in this case was that, historically, the rules may have provided benefits that fell short of the statutory minima introduced in the PFSA. This raised the question of how much former members who had been topped up to their minimum benefit level should have received in residual surplus if they had already received more than what was provided for in the rules prevailing at the time their benefits were paid. On the other hand, there were current and future generations of members who had been promised benefits in the rules that may have been, at least in part, funded by paying exiting members benefits less than the minimum benefit level.

6.4.4 The third test is to consider what would be just. This might have required some consideration of how the surplus had arisen in order to determine how it should be allocated. A reliance on the analysis of surplus could have been considered. This was not necessarily a definitive indicator as the order in which sources of surplus were analysed could contribute to their relative weighting and hence the distribution of surplus. The argument that the employer carried the risk of under-performance under a DB structure suggests that there would be some justice in allocating residual surplus back to the employer (Milburn-Pyle & Lennox, 1990). When it came to pensioner, current-member and former-member stakeholders, a careful analysis of the prevailing rules, cross-subsidies inherent in the scheme—and the extent to which these were just on an objective basis—and the sustainability of the fund was required. The need to maximise the interests of the “worst off” per Asher (1998) could be interpreted as favouring the current members and former members over the interests of the employer. However, Andrew (op. cit.) observed that general actuarial practice seemed to favour the employer. Asher (2001) refers to this as the paternalistic paradigm and argues that a “middle paradigm” with neither the employer nor employee having a dominant moral claim would have been more appropriate.

6.4.5 The fourth test considers the obligations placed on the trustees in terms of their relationship with various stakeholders. This raises the issue of impartiality as well as avoiding conflicts of interest. An interesting nuance is that section 15J of the Pension Funds Act set out requirements for the payment of surplus to the employer to prevent job losses. Thus, trustees were required to apply their minds to relationships between stakeholders that were extrinsic to the fund itself as it could be argued that active member interests were positively addressed where a surplus allocation to the employer meant that the employer could continue to operate. Asher (2001) points out that after considering the claims of various stakeholders in an impartial manner, different boards of trustees might have come to different decisions regarding the distribution of benefits, all of which could be considered reasonable. This highlights that it is the process rather than the outcome that should be assessed in evaluating the ethics of the decision.

6.4.6 The fifth test is whether the decision-makers encompass the right virtues. The trustees needed to ensure that they have actively considered the interests of all eligible stakeholders and that they were satisfied that they have exercised impartiality between

members and avoided conflicts between members and other stakeholders in making the allocation. The public interest and the precedent set by any decision should also have been considered. The actuary should furthermore have ensured that all factual information had been properly presented to facilitate a diligent decision.

### 6.5 Develop the Solution: Make a Decision

The exercise of discretion meant that a fair degree of subjectivity characterised the decision-making process. Circular PF114 issued by the FSB set out standards for the communication of the scheme in a way that is “clear and comprehensive” to all stakeholders. This communication requirement can be considered as a final test of equity based on the comments and complaints to which it gives rise.

### 6.6 Monitor the Solution: Future Decision-Making

The analysis of the surplus available at the SAD makes for interesting reading in its own right. Davis & Kendal (op. cit.) considered 447 DB funds and analysed the change in surplus from the statutory valuation prior to the SAD and the valuation at the SAD. This is shown in Table 1. Davis & Kendal (op. cit.) noted that in the sample of valuation reports at the surplus apportionment date that they reviewed, the majority had not used the same basis as at the previous valuation. This suggests either that the trustees, on the advice of the actuary, felt that there was good reason for not adopting a best-estimate basis, or that the previous valuation was not prepared on a prudent basis in line with professional guidance in place at the time. On aggregate, the bases of the funds were strengthened between the two valuations. This resulted in a significant reduction in distributable surplus. It is thus conceivable that the decision-makers prioritised long-term solvency over the short-term aims of the PFSA.

TABLE 1. Analysis of change of surplus

	Rm	
Previous surplus	15 266	100%
Interest	5 372	35%
Pension increases	-5 297	-35%
Benefit improvements	-2 210	-14%
Contributions	-1 955	-13%
Other ‘controllable’	-929	-6%
Improper use	381	2%
Experience	4 372	29%
Change in basis	-9 928	-65%
Expense reserves	-272	-2%
Distributable surplus	4800	31%

## 6.7 Concluding Remarks

The surplus apportionment process appears to have disappointed the original proponents of the regulatory amendments, who sought an allocation of surplus to the former members of these funds (Davis & Kendal, *op. cit.*). Anecdotally, there are suggestions that the reputation of the actuarial profession may have been tarnished in the process. The principle of justice applied here is that the interests of all stakeholders have been fairly and properly considered. A key test of this objective was the communication process. This case study also suggests that an ethical decision may err on the side of the most vulnerable members but that they may be extremely difficult to identify if the fund is a going concern. In addition, the principles of diligence and impartiality require the consideration of all information in an objective manner. In this case, though the regulator required the trustees to demonstrate that they had followed a decision-making process, this included the exercise of considerable discretion with respect to residual surplus. The onus on the actuary was to certify the reasonability of this process and this implied the need for a benchmark decision-making framework.

## 7. CASE STUDY 2: INVESTMENT STRATEGY OF A DEFINED-CONTRIBUTION FUND

The second case study concerns the review of an investment policy statement (IPS) as required by PF130. This is a common ethical problem in retirement funds. For illustrative purposes, one can consider a DC retirement fund with no member-level investment-channel choice. Therefore, the trustees are required to set one investment strategy for all members of the fund.

### 7.1 Specify the Problem: Recognise the Ethical Issue

7.1.1 The IPS describes the investment strategy that the DC fund employs to meet the objectives of the fund. The authors recognise that the ethical issues that arise in this process are substantial. Asher (1998) suggests the following issues for consideration:

- the trade-off between maximising return subject to an acceptable level of risk;
- foregoing extra return in the interest of socially responsible investments;
- the extent to which trustees should exercise shareholder activism;
- the selection of investment managers;
- measuring the performance of investment managers;
- asset allocation;
- the selection of individual securities; and
- the consideration of the environment in investment decision-making.

In light of these complexities, the authors limit attention to the broader ethical issues that arise in this process. They consider whether the general process used to determine the investment strategy is ethical and whether the IPS allows trustees to discharge their duty of setting an investment strategy to meet the purpose of the fund ethically. The responsibilities of the actuary making recommendations with respect to the IPS include:

- ensuring that the trustees are aware of the risks associated with the strategy adopted;
- explaining how these risks may affect various stakeholders such as the members, pensioners, employer and other market participants;
- carrying out the asset-liability modelling using prudent assumptions and parameters;
- valuing assets; and
- gathering information.

The actuary should also ensure that the IPS covers responsible asset ownership and sustainability issues.

7.1.2 A key dilemma in the IPS is the trade-off between long-term and short-term considerations. In the long-term, the fund would like the highest return for an acceptable degree of risk. However, certain members, such as those close to retirement or contemplating withdrawal, may have a much shorter time horizon. This is also an individual-versus-community dilemma, as half the trustees may be members of the fund with a vested interest in the decision made. Balancing the needs of various groups could also be a justice-versus-mercy issue. Loyalty to a specific under-performing asset manager may be a key consideration. The IPS would need to assist the trustees in managing this truth-versus-loyalty dilemma going forward.

## 7.2 Develop the Solution: Gather Information

7.2.1 The trustees need to gather information regarding the nature of the fund's liabilities. In a DC fund, the accounting liability is simply the members' accumulated fund credit, which is determined by the investment returns, which is, in turn, a function of the investment strategy. Since this fund does not have member-level investment choice, the trustees may use a target replacement ratio for the purpose of setting the investment strategy. The range of target replacement ratios in the literature is extremely broad and the appropriate target would depend on a number of factors including salary definition (Butler & Van Zyl, 2012). The trustees are likely to rely on projection assumptions recommended by the actuary in assessing the projected retirement outcomes against the targeted replacement ratio.

7.2.2 The demographics of the membership would influence the implicit liability. Therefore, information on the age, gender and income of members will need to be gathered. At a collective level, information about attitude to risk would be helpful. Information on the members' current wealth is helpful for members who join the fund later in life. The extent to which the member-specific information is used would depend on the extent to which such information is available, how significant any additional information would be, the sophistication of the model being used, and the level of communication to members. Gathering sensitive information may itself raise ethical issues, particularly around confidentiality. Arguably, the member should be engaging with a financial adviser to assist them in managing their wealth outside the retirement fund. Nevertheless, this information on current wealth would assist trustees in setting an appropriate investment strategy. Most importantly, in order to assess reasonable benefit expectations of members the needs of members would need to be assessed and so communication with members becomes important.

7.2.3 Information relating specifically to investments would need to be gathered; for example, categories of investments, expected investment returns, risks associated with different investments and correlations between expected returns on investments. This is not purely a technical enquiry as there may be various ethical considerations that arise from different investments. These considerations might include the generation of returns from companies that extract monopoly rents, charging of interest on credit to the poor and investing in companies that produce morally abhorrent products (Asher, 1998). It is part of the fiduciary responsibility of trustees to determine the “moral sensibilities” of the members and to look after such interests through the investments made by the fund (Asher, 1998). It is recognised that institutional investors frequently fail to invest in small businesses and trustees should enquire with their investment managers as to the investment merits of such investments (Asher, 1998). Additional information on the trustees’ attitude towards passive-versus-active management, shareholder activism (Asher, 1998), performance-based fees and environmental concerns (Asher, 1998) will be required. Similarly, the degree to which the trustees have the skills and expertise to become involved in the setting of the investment strategy should be ascertained and remedied.

7.2.4 The methodology for determining the optimal asset allocation to meet the implicit liability would need to be outlined and tested. Because utility theory provides a foundation for evaluating objectives and discussing them, Asher (1998) suggests that the optimal approach is to use a utility function, or at least a reasonable approximation to a utility function, and then maximise utility given the statistical distribution of returns. Thomson & Reddy (unpublished) use expected utility theory to quantify the risk aversion of trustees for the purposes of asset allocation. The models used to determine expected returns and risk premiums would need to be justified and tested. The asset-liability model is seldom produced by the trustees themselves but rather by the actuary, who has an ethical duty to apply due care in creating the model and selecting its parameters. Asher (1998) stresses the degree of care required and complexity involved in this process. According to Asher (1998), assets should only be purchased, or sold, once their value has been methodically determined, which often is the responsibility of the actuary.

7.2.5 Information on the fund’s liquidity requirements, cashflow requirements and current financial status would need to be gathered. Greater shareholder activism on the part of the trustees should include questioning the size of the dividends declared by the entities they invest in as these dividends enhance the fund’s liquidity (Asher, 1998).

7.2.6 Information on the current asset managers, their mandates, benchmarks and performance fees would need to be gathered.

7.2.7 The actuary may assist in gathering this information and using it to provide a recommended investment strategy.

### **7.3 Understand the Environment: Consult Legislation, Guidance and Regulation**

Section 36(1)bB of the Pension Funds Act permits regulations limiting the amount and the extent to which a pension fund may invest in particular assets or in particular kinds or categories of assets, prescribing the basis on which the limit shall be determined and

defining the kinds or categories of assets to which the limit applies.<sup>24</sup> These limits are set out in Regulation 28.

#### 7.4 Develop the Solution: Evaluate Possible Options

7.4.1 The first test is whether the fund complies with the law or regulation. The fund would need to ensure that its current investments do not breach the limits as specified by Regulation 28. However, as stated in ¶2.2.3, an ethical decision is one that is both legally and morally acceptable. Therefore, even though the fund may not be in breach of any regulatory limits, the trustees would need to consider whether the current and future investments of the fund are appropriate to ensure that the members' interests are protected at all times, as discussed in ¶3.1.2. For example, Regulation 28 allows the fund to invest a maximum of 75% of its assets in equity,<sup>25</sup> but holding 75% in equities may not be ethical if such an allocation does not protect the interests of members at all times. If contravening the regulation is based on ethical grounds then this would lead to an opportunity to lobby for a change to the regulation or to appeal for a special allowance.

7.4.2 The second test is to consider the primary purpose of the fund, most commonly to provide a benefit on retirement. In DC funds, the benefits, particularly on withdrawal or retirement, are a function of the contributions, less expenses, that are accumulated with investment returns. As mentioned in ¶7.2.1, a target replacement ratio can be set. However, the replacement ratios generally used do not give appropriate consideration to the needs of the members. The trustees would need to consider the reasonable benefit expectations of members and set a replacement ratio accordingly. Even in this instance, a single target replacement ratio may not be appropriate for all members (Butler & Van Zyl, *op. cit.*). The options available to members at retirement would need also to be considered, specifically whether the investment strategy matches the underlying investments of the retirement options when targeting a particular benefit at retirement. Given the purpose of the fund, the responsibility of the trustees in terms of its investments is to maximise returns subject to an acceptable level of risk. This objective needs to be addressed in the light of other ethical issues that are becoming increasingly relevant, for example consideration of sustainability issues and attention to externalities such as job creation (Asher, 1998). Actuaries can assist with such trade-offs (Reddy & Thomson, unpublished).

7.4.3 The third test is to consider what would be just. The definition of justice would involve consideration of the needs of various stakeholders and the balance between of these needs (Asher, 1998). In determining the reasonable benefit expectations of members, the trustees would need to consider the needs of the members. The trustees would also need to consider the stakeholders who require the most protection and the corresponding needs of other stakeholders. This in turn requires the identification of the fund's stakeholders. In addition, because the fund does not have member-level investment choice, the investment

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24 Act 24 of 1956, *supra*

25 Amendment of Regulation 28 of the regulations made under Section 36, Government Gazette No. 34070, 4 March 2011

strategy will be set based on the circumstances of the average member. But the needs and circumstances of individual members may differ. For example, members may have other sources of income or be more or less risk-averse than the average member. Therefore, choosing a one-size-fits-all approach is inherently unjust because it may be suitable for some members and unsuitable for other similar members. Justice would also play a crucial role in the selection of individual investments, given the ethical considerations inherent in various asset classes as raised in ¶7.2.3.

7.4.4 The fourth test considers the obligations placed on the trustees and actuary in terms of their relationship with the stakeholders. This may relate to the communication between the trustees and beneficiaries. Usually members receive information on the value of their accumulated fund, the fund's investment performance and the average costs per member. The communication is commonly from the trustees to the members, but the actuary may need to alert the trustees to material risks that should form part of this communication. The obligations placed on trustees regarding their relationship with the members requires trustees not only to resolve member's complaints but also to engage with members on understanding their needs, determining that their needs are being met and providing clarity on information that the members do not understand. This obligation could also be extended to consider whether the communication to members provides them with all the information required to evaluate the adequacy of their retirement provision, including the salary definition on which any replacement ratio is based. The inclusion of benefit illustrations may serve as a key communication to members for this purpose. The method and language of communication also raises ethical issues as discussed in ¶¶5.5.1–5.5.3. In addition, because the members bear the investment risk, they need to be fully informed of the nature of the risk that they bear. Allowing the member to bear the investment risk without full disclosure would not pass the fourth test.

7.4.5 The fifth test is whether the decision-makers demonstrate the right virtues. For trustees, this implies diligence, impartiality, objectivity and prudence. For actuaries, additional requirements are integrity, confidentiality, scepticism, courage, reflection and a commitment to the public interest. Trustees are required to perform due diligence on the information gathered in ¶7.2. But part of the due diligence process is to address the ethical issues that arise in determining the investment strategy. In addition, the virtue of diligence needs to be balanced with the public interest. The incorporation of sustainability into investment decisions and ethical investments addresses the issue of the retirement fund acting in the public interest. The amended Regulation 28 deals with the former and PF130 deals with the latter. The conflicting requirements suggested by both are discussed in ¶¶7.4.6–7.4.7. Thomson & Reddy (op. cit.) make a distinction between the prudence exercised by actuaries and trustees. For the former, prudence refers to “deliberate conservatism in the setting of assumptions and the determination of model parameters” and for the latter, prudence refers to the “risk aversion of trustees”.

7.4.6 Trustees have to consider whether their investment decisions are in the public interest, protect the environment and uphold good governance. Asher (1998) also calls for greater involvement of trustees in corporate governance and environmental issues.

Therefore, the virtue of prudence needs also to be balanced with the public interest. As outlined by Reddy & Thomson (op. cit.), since environmental, social and economic sustainability are connected, sustainability is affected by the investment choices that institutional investors, in particular retirement funds, make and it affects the choices they make. The amended Regulation 28 thus requires the fund to consider the effects of its investment decisions on the environment, society and economy, as well as the effect of sustainability concerns, such as resource constraints, on its investment strategy.

7.4.7 In contrast, according to PF130, the primary obligation of trustees is to provide optimum returns for their beneficiaries and only once these returns have been met, should funds consider ethical investments.<sup>26</sup> In this case, it may be considered unethical for the fund to invest in underperforming assets, even if they are considered to be ethical investments, since optimum returns need first to be achieved. PF130 does not provide the time horizon over which the trustees need to deliver these returns. To achieve sustainability, the fund would need to take a long-term view of returns. In addition, optimum returns may be affected by the effects of unsustainability (Reddy & Thomson, op. cit.). For example, Jones et al. (unpublished) concluded that resource constraints would place a limit on future economic growth rates and hence investment returns are expected to be lower. For this reason, in the pursuit of optimum returns the fund would need to consider the effects of unsustainability on investment returns. PF130 suggests that an ethical outcome would be achieved by investing in companies that meet certain criteria. However, such ethical investments do not consider the effect of that investment decision on society or the environment or whether the members themselves consider such an investment to be ethical. Also investing in a company on the basis of positive externalities, such as job creation, which in itself is a step in the right direction, ignores the effect of negative externalities, such as pollution, on investment returns. It is these effects that determine whether a decision is moral or not, as described in ¶2.2.3.

## 7.5 Develop the Solution: Make a Decision

The revised investment strategy that the trustees decide on should enable them to discharge their duties ethically and should also demonstrate that an ethical process had been undertaken to arrive at that strategy and that significant ethical issues were recognised and addressed. The trade-offs that were addressed should reflect that the best interests of the members were served. PF130 states that when a decision is being made by the trustees they should obtain expert opinion and advice but that care must be taken to ensure that the advice obtained is free from conflicts of interest.<sup>27</sup>

## 7.6 Monitor the Solution: Future Decision-Making

Not all of the ethical issues that arise in setting the investment strategy would be addressed by the framework but the process of identifying them would assist trustees to

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26 Financial Services Board, Circular PF NO. 130: Good Governance of Retirement Fund: Annexe B, *supra*

27 *Ibid.*

question the ethics behind the decisions they make regarding investments and provide information for future decision-making. Part of monitoring the solution would be assessing whether the investment strategy delivers on its objectives. The measurement here would depend on the specific objectives of the fund but this analysis would in all likelihood be more sophisticated than a consideration of returns. Given the long time horizon for retirement fund investing, the trustees would probably consider whether the investment strategy is meeting its objectives at least quarterly. In the experience of the authors, underperformance is likely to result in an inquiry as to the reason for underperformance as opposed to an immediate change to the investment strategy. However, the strategy is likely to be formally reviewed every one to three years.

### 7.7 Concluding Remarks

This case study emphasises that the requirement for trustees to act prudently regarding setting an investment strategy is more about the process involved than its outcome. It is recognised that the setting of investment strategies opens the trustees and actuaries to many ethical issues, not limited to the issues discussed in the case study. This framework would assist both the trustees and actuaries to flesh out these issues and address them. Considering actual return on assets is a relatively small part of the corresponding process and is secondary to the process of arriving at the IPS in an ethical manner.

## 8. CASE STUDY 3: DEATH BENEFIT DISTRIBUTIONS

The distribution of death benefits is a trustee duty that is set out in Section 37C of the Pension Funds Act. This piece of legislation requires trustees to pay death benefits to the dependants of the deceased. Once the needs of the dependants are met, the residual death benefit can be paid to beneficiaries specified on a beneficiary nomination form. However, there is scope for considerable trustee discretion firstly in identifying dependants, secondly in ascertaining what would meet their needs and, thirdly, in identifying beneficiaries for the residual. A first class of dependants is a legal dependant where the dependency is automatic in terms of the law. This includes minor children and spouses. A second class of dependant is that of factual dependants who are financially dependent on the deceased and have an expectation that this support will continue even though this support is not recognised in law. Ascertaining need can range from meeting maintenance orders to sharing family incomes. Identifying beneficiaries can be made complicated by old or incorrectly populated forms. Complaints regarding the distribution of death benefits represent 10% of matters brought before the PFA.<sup>28</sup> Death benefit distributions thus represent a considerable risk to trustees. While actuaries may be involved in the data evaluation process and advising on the quantum of the loss of support experienced by various parties as a result of the death of a breadwinner, the discretion with regard to benefit allocation rests with the trustees.

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<sup>28</sup> Pension Funds Adjudicator, 2012/2013 Annual Report. [www.pfa.org.za](http://www.pfa.org.za), 18/07/2014

## **8.1 Specify the Problem: Recognise the Ethical Issue**

8.1.1 As death benefit distribution involves the trustee carrying out their duties, it is an inherently ethical issue. Ethical duties also apply to actuaries assisting them in this process. It is also an obviously ethical issue in that it involves paying death benefits to those who were dependant on the deceased member and can have a significant impact on vulnerable beneficiaries. Ethical issues also arise in the communication with potential beneficiaries, particularly where relationships are adversarial or where potential beneficiaries are unaware of each other's existence.

8.1.2 Justice and mercy may be at odds in the distribution process. While there may be certain individuals with a stronger claim to the benefit, there may also be beneficiaries who are particularly vulnerable and for whom a larger benefit would mean a significant improvement in their quality of life. It is also possible that certain trustees may know the beneficiaries personally and may thus face a truth-versus-loyalty dilemma. A further consideration is that death benefit distributions should be completed within twelve months and that the beneficiaries often need the money much sooner than this. There is thus a conflict between resolving the issue as quickly as possible and taking the time to perform full investigations. This is a long-term versus short-term tension. An individual-versus-community tension may arise in the selection of beneficiaries, some of whom may be supporting larger families. This individual-versus-community dilemma ties in again with the justice-versus-mercy dilemma, in that it may be more merciful to give a larger benefit to a person supporting a larger family even if another party has a stronger legal claim.

## **8.2 Develop the Solution: Gather Information**

The facts of a certain case were that a male member of a specific retirement fund passed away in July 2011 with a gross death benefit of approximately R870 000. The deceased had a spouse, MV, who had a child of her own, PM, from a previous relationship. PM lived with the deceased and MV and was a grade 10 learner when the deceased passed away. No information was provided on the whereabouts of PM's father. MV was employed but no information was available regarding her earnings. The deceased had three children from a previous relationship: KN, K and KC, aged 31, 28 and 26 respectively at the time of the death. There was no completed beneficiary nomination form on file. KN and K were working and withdrew their claims for support. KC was due to complete a degree in mining engineering at the end of 2013. KC was receiving a monthly allowance of R2 500 in July 2011. These facts represented all the information that the trustees had at their disposal when making the death benefit distribution.

## **8.3 Understand the Environment: Consult Legislation, Regulation and Guidance**

8.3.1 The relevant portions of Section 37C of the Pension Funds Act read:

- 1) ... Any benefit ... payable by such a fund upon the death of a member, shall, subject to a pledge in accordance with section 19(5)(b)(i) and subject to the provisions of sections 37A (3) and 37D, not form part of the assets in the estate of such a member, but shall be dealt with in the following manner:

- a) If the fund within twelve months of the death of the member becomes aware of or traces a dependant or dependants of the member, the benefit shall be paid to such dependant or, as may be deemed equitable by the fund, to one of such dependants or in proportions to some of or all such dependants ...

8.3.2 The Promotion of Access to Information Act<sup>29</sup> (PAIA) applies and should be considered in light of the Protection of Personal Information Act<sup>30</sup> (POPI). Section 63 of PAIA suggests that trustees must refuse a request for access to information if that “would involve the unreasonable disclosure of personal information about ... [the] deceased individual”. POPI allows trustees to collect, record, collate, use and disseminate information if it is required by law or if doing so occurs in the proper performance of legal duties.

#### **8.4 Develop the Solution: Evaluate Possible Options**

8.4.1 The first major decision is whether all the benefit should go to one of KC, PM or MV or if it should be shared. There are four options here. Should the benefit be shared, there are infinitely many options.

8.4.2 The first test is whether the option complies with the law or regulation. The facts here are not entirely clear. If MV out-earned the deceased by some margin, it is possible that she was not factually dependant on him. MV has a legal obligation to support PM as does PM’s father. Even though PM was living in the same household as the deceased, there may well be circumstances where PM is not factually dependant on the deceased. KC was clearly factually dependant on the deceased. This means that any solution must include KC as a dependant.

8.4.3 The second test is to consider the purpose of the fund. In this instance, the purpose which is to provide a benefit on death. Section 37C informs our understanding that this is primarily to support those who are dependent on the deceased.

8.4.4 The third test is to consider what would be just. Given the emphasis that Section 37C places on supporting dependants, a just distribution would favour those who cannot support themselves or have no other source of support. A quantification of the support lost by various dependants may thus inform a just distribution and the actuary may assist in this regard. The extent of the needs of PM, MV and KC are difficult to ascertain without further factual information.

8.4.5 The fourth test considers the obligations placed on the trustees in terms of their relationship with various stakeholders. A key stakeholder is the state, which would otherwise have to provide for dependants who have no alternative sources of support. In addition, they have the duties to establish the level of need among the various beneficiaries and then to communicate with the potential beneficiaries. Trustees will need to consider PAIA and POPI requirements in this regard. This means communicating about the various beneficiaries only to parties with a genuine need to know. This is a test in two respects, with

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29 Act 2 of 2000, Republic of South Africa, as amended

30 Act 4 of 2013, Republic of South Africa, as amended

whom the trustees communicate and what is communicated. For example, a widow would need to know about her deceased's husband's child born to a girlfriend as well as that child's age because the child would reduce her allocation and any allocation to her children. The widow would not, however, need to know of the identity of the child, their sex or where he or she lives.

8.4.6 The fifth test is whether the decision-makers encompass the right virtues. For trustees, this implies diligence, impartiality, objectivity and prudence. For actuaries, additional requirements are integrity, confidentiality, scepticism, courage, reflection and a commitment to the public interest. In order to test any decision against these virtues, it would be essential to garner more factual information as otherwise the test for diligence is not met. However, the virtue of diligence needs to be balanced with the public interest. Further investigations take time and beneficiaries often require money shortly after the death of a breadwinner. Hence exhaustive, expensive searches may be unethical.

### **8.5 Develop the Solution: Make a Decision**

Ultimately, the trustees awarded 7% of the benefit to KC, 13% of the benefit to PM and 80% to MV. The trustees were unable to justify this decision and later when the case was appealed, the PFA found that they had not sourced sufficient factual information to make any decision, either before making their initial allocation or before the matter was brought before the PFA. The ultimate allocation of the death benefits is not a matter of public record.

### **8.6 Monitor the Solution: Future Decision-Making**

In this case, the framework leads us to conclude that the most ethical decision would have been to defer making the decision until sufficient information was at hand. The result suggested that the trustees prioritised the short-term outcome over the long-term objective of a fair distribution. This means that the trustees will need to consider the level of diligence applied to death benefit determinations in future. Given the time limit on death benefit distributions, this may mean that investigations will need to commence earlier and that trustees may need to consider the time frames for the processes followed in order to complete all necessary investigations in good time. In addition, the result suggests that the trustees favoured showing mercy towards MV and PM over the legal claim of KC, without any justification.

### **8.7 Concluding Remarks**

This case study emphasises that sometimes halting the decision-making process to gather more information is the most ethical approach. However, in cases such as these, such an approach needs to be weighed up against the fact that the dependants may need and expect a rapid decision. It also highlights the importance of trustees being able to justify their decisions.

## 9. CASE STUDY 4: DEFAULT ANNUITISATION STRATEGIES

Members of retirement funds face the risk of outliving their income (Albrecht & Maurer, 2002). This longevity risk coupled with inadequate advice has prompted the South African government's National Treasury to propose that trustees of retirement funds should choose a retirement income product for members that do not choose an alternative.<sup>31</sup> These proposals are likely to be refined in the future. The 2012 proposals have been used for this case study. Given the technical issues involved, it is likely that actuarial input may be requested by trustees as a result of these and future proposals.

### 9.1 Specify the Problem: Recognise the Ethical Issue

9.1.1 For an individual, the choice of a retirement income product brings with it a number of risks. These include longevity risk (Albrecht & Maurer, *op. cit.*) and inflation risk (Emms, 2010). Other risks include experiencing a consumption shock that the product is not flexible enough to finance and the risk of counter-party failure. Choosing a default, trustees would need to consider the risk taken on by the members and hence must act in a fiduciary capacity. Given the extent to which this influences the rights of members, it is intuitive that the principles of justice must apply in the decision-making process. This underscores the fact that this is an ethical issue.

9.1.2 A clear dilemma is the trade-off between the short-term need for income against the longer-term need for sustainability of income or bequest. As this is a default option, it will apply to all members who do not make an election, regardless of their circumstances. The question thus arises as to whether trustees will choose the option best for all members or the option best for that subset of members who are unlikely to be in a position to make an informed decision for themselves. This is an individual-versus-community dilemma. Truth-versus-loyalty dilemmas will also arise for trustees who have the conflicts of interest associated with their status as active members. Justice-versus-mercy is less of a consideration in this decision as members do have a choice.

### 9.2 Develop the Solution: Gather Information

9.2.1 The proposals are set out in the National Treasury discussion paper on enabling a better retirement income.<sup>32</sup> The proposal in that paper is that retirement lump sums of less than R150 000 are not to be subject to annuitisation. For larger retirement benefits, up to one-third may be taken in cash with the remainder annuitised. Retirement benefits of less than R1,5 million must be used to purchase either the default product chosen by the trustees or another qualifying product chosen by the member. The latter is referred to as the opt-out option. National Treasury suggested three possible options for annuitisation, namely a conventional life annuity, a retirement income trust (RIT) and a variable annuity. Any retirement benefits in excess of this ceiling may be invested in any product of the member's choice including

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31 National Treasury, Enabling a better retirement income, Technical Discussion Paper B for public comment, September 2012

32 National Treasury, September 2012, *supra*

products that do not provide longevity protection, such as income-drawdown accounts. At the time the discussion paper was written, a retirement lump sum benefit of R1,5 million could buy a monthly income of between R5 000 and R7 500 per month increasing with inflation.

9.2.2 Under the conventional life annuity option the fund would need to obtain quotes from a number of different providers for a life annuity with a 5-year guarantee period, a fixed increase of either 50% of CPI or 3% and a spouse's pension of two-thirds of the main member's pension commencing on the member's death. The member would then select a quote or use any other approved annuity vehicle. If the member does not choose then the trustees can select the best annuity for them.

9.2.3 The RIT is a new type of vehicle that National Treasury hopes to introduce as part of the reforms. The product looks like an income-drawdown account in its initial phase with members having to drawdown the account between a minimum and maximum drawdown rate. If a member's balance drops below a threshold level, referenced against the amount required to buy a certain level of income in the conventional annuity market, then the balance is used to buy a conventional life annuity immediately. Otherwise, the account is later used to purchase incrementally a series of conventional life annuities for the member.

9.2.4 A variable annuity is a type of with-profit annuity where the mortality and investment profits are shared between the member and the insurer. The income paid to the annuitant is adjusted upwards and possibly downward to reflect the profit or loss arising. These annuities may or may not have a death benefit attached.

### 9.3 Understand the Environment: Consult Legislation, Regulation and Guidance

There is currently no regulation or legislation in this regard. However, the National Treasury discussion paper sets out the rationale for the default. The key concerns are that assets are depleted too quickly and costs are too high and difficult to compare. PF130 should also be considered in terms of its general applicability for good governance in retirement funds as well as the guidance it contains on setting investment strategies, which can apply to the pre- and post-retirement periods.

### 9.4 Develop the Solution: Evaluate Possible Options

9.4.1 The first test is whether the option complies with the law or regulation. All three default options pass this test for the purpose of this discussion as they were recommended by National Treasury.

9.4.2 The second test is to consider the purpose of the fund. In this case, the purpose is to provide a benefit on retirement. The discussion paper emphasises the importance of an income benefit in old age that can provide a benefit for life. For the conventional annuity option, the spouse's reversion and guarantee providing for a death-in-retirement benefit might not be consistent with the aim of providing retirement income benefits. However, death-in-retirement benefits are usually considered fair as they create consistency between members who die just before or just after retirement. The 50% match to inflation means that over time the pension loses purchasing power which reduces the extent to which the retirement benefit will meet the needs of the member. For the RIT, longevity protection is provided by the

mechanism that switches the member to a conventional annuity once the fund drops below a certain level. This may avoid the risk of the member running out of funds completely, but will lock in large losses which may result in a lower income in retirement than may be required to meet the needs of the member. If a member experiences a market crash early in their retirement, their retirement income may be permanently negatively affected. This can be avoided to a certain degree if the RIT investments are matched to those backing the target annuity. However, this cannot be guaranteed if the member is able to select their investment strategy. The long-term suitability of this option would also be determined by the choice of the target annuity. For the variable annuity, the suitability of the product to provide a retirement benefit depends on the degree to which members share the profits and losses, the pricing basis and the ongoing management of the product. A level of guarantee to the income level may provide some sort of security but this allows for less competition between providers than the other options.

9.4.3 The third test is to consider what would be just, meeting the needs of the individual as well as balancing the competing rights and needs of various groups of members and other stakeholders. Although there is a death-in-retirement benefit inherent in the conventional life annuity product, it implies a cross-subsidy from those with heavier mortality to those with lighter mortality within the same rating category. Thus, unless relatively fine rating factors are used to ensure that lives in the same pricing category are sufficiently homogeneous, the resulting cross-subsidies may be considered inherently unfair. A further issue is the fact that the annuity is purchased at the retirement date when annuities may be relatively expensive or cheap. If the fund's investment strategy is not matched to the target annuity, this can result in otherwise identical members having very different income levels in retirement. A low match to inflation is more suitable for lives with heavier mortality than those with light mortality, who would experience a greater devaluation of real income over their lifetime. This too may be regarded as unfair. The spouse's reversion may result in over-insurance in households where both spouses work and thus not meet the needs of certain classes of members. The RIT option reduces the level of cross-subsidy between members as there is initially no risk pooling. In addition, because the purchase of the annuity would be phased, members' exposure to volatility in the annuity market is much reduced. A third benefit is that it allows for greater income flexibility, which would allow retirees to adjust to a consumption shock. However it should be noted that it allows for investment in more risky assets which exposes members to the risk that experience is adverse. Although a higher income is expected to arise from a riskier strategy, a much lower income could be purchased if experience is adverse. This option would only be fair if all members understood the potential upside and downside investment risk that they were taking on at inception. The variable annuity allows members to share in profits or losses. However, the extent to which this is fair depends on how rapidly these profits and losses are shared and if there are inter-generational subsidies. In addition, it may be difficult for trustees to justify why a particular level of profit participation is chosen given that different groups of members may have different risk tolerance.

9.4.4 The fourth test considers the relationship between the trustees and beneficiaries. The duty of care means that trustees would need to source the conventional

annuity quotes from reputable insurers and present all necessary information to the member in a form that they understand. This is not limited to the quote information but also the rationale behind the panel. Unless trustees assist members to interpret this information then it is unlikely that this option can pass this test. For the RIT option, the duty of care would involve selection of an appropriate RIT vehicle and disclosure of all information regarding the RIT and associated risks. It would also mean assessing the ongoing communication provided by the RIT to ensure that the RIT continues to provide adequate disclosure to members. The selection of an appropriate RIT vehicle would lead to further ethical considerations. The variable annuity leaves members exposed to risks inherent in the ongoing management of the variable annuity product. This means that trustees would need to be satisfied that the variable annuity would be governed in a responsible manner by a reputable service provider.

9.4.5 The fifth test refers to virtues. For the conventional life annuity, this means that the panel of insurers needs to be appropriately selected. Given the concerns about whether annuity pricing accurately reflects the heterogeneity in mortality, it may be necessary to have a different panel for impaired lives or lives where the mortality is expected to be heavier. If the member cannot make a decision, the trustees must make one on their behalf in which case the trustees need to demonstrate fair and objective decision-making, possibly by giving clear reasons why one service provider was preferred to another. For the RIT option and variable annuity options, the trustees would need to demonstrate similar diligence.

## **9.5 Develop the Solution: Make a Decision**

9.5.1 The trustees would have to determine the appropriate default option and justify the decisions relating to offering the option selected. As it stands, the framework suggests that none of the three options pass all the tests. If this is to become a regulatory requirement, trustees would have to select the most ethical of three imperfect solutions.

9.5.2 This decision would need to be communicated fully and clearly to members. The member might have more than one retirement fund at the time of their retirement and would need to consider the implications of decisions made by different trustee boards as well as their options should they choose to opt-out as discussed in ¶9.2.1. The actuary advising the trustees should ensure that risks of different options are adequately disclosed. The actuary should also be mindful of how any benefit illustrations may have affected members' reasonable benefit obligations and ensure that such illustrations are consistent with the options available at retirement. As noted in ¶7.4.4 above, it could be argued that the provision of benefit illustrations is a key communication in ensuring that the members are aware of their likely retirement income and can make timeous additional provision if necessary.

9.5.3 Given that none of the three defaults are likely to fully satisfy all ethical tests, the most ethical option for trustees may be to encourage members to exercise their right to choose, irrespective of what option is selected as the default.

## **9.6 Monitor the Solution: Future Decision-Making**

The trustees would need to monitor actual experience of members in the default options and how members would have fared under alternative options in order to review their

default decision. The latter is difficult, and potentially expensive. The experience required for meaningful input into the decision-making process may take a number of years to emerge. The proportion of members opting out would also need to be observed as this indicates the relative importance of the default. Selection of opt-out options would also need to be monitored.

### **9.7 Concluding Remarks**

This case study emphasises that a decision that is fully compliant with regulation may not in itself be ethical. The framework would suggest that the most ethical option is pursued. In this case, the framework suggests that the most ethical decision by the trustees may be to facilitate choice by the member.

## **10. SUMMARY AND CONCLUSION**

10.1 The aim of this research paper was to explore how the somewhat abstract and broad concept of ethics can be applied to the day-to-day process of decision-making in South African retirement funds. It is important to differentiate between the role of the trustees who are the decision-makers and that of actuaries who act as advisers to the trustees and participate in decision-making. To address this aim the authors considered the extent to which the discharge of duties placed on trustees and actuaries leads to ethical issues and the extent to which a framework for decision-making might assist trustees and actuaries in the process of ethical decision-making.

10.2 Establishing whether the discharge of duties faced by trustees and actuaries led to ethical issues requires an understanding of what is meant by the term 'ethics'. The ethical theories selected have, in the opinion of the authors, the closest correspondence with the decision-making of trustees and actuaries. The theory of right action holds that an individual action can be assessed as right or wrong. The theory of justice can aid in making this distinction. Consequentialist theories of right action assess the outcome of an action. Deontology examines the rules and process behind the action. Virtue ethics considers primarily the motivation for any action, the process being a secondary consideration. The ethics of care, in contrast, focuses on the relationships between the stakeholders and how their needs are met. The authors acknowledge that their exploration of ethical theory has been brief. A thorough analysis of ethics for all actuarial applications is left for future research.

10.3 The legal, regulatory and professional duties of trustees, and the actuaries who advise them, can be mapped to these ethical theories. Trustees need to use the purpose of the fund to guide their thinking on what is just. The virtue of justice needs to guide their decision-making. The relationship between the trustee and fund beneficiaries should also be scrutinised in terms of rights, duties and obligations. Ultimately, trustees should develop the virtue of accountability in addition to the virtues of diligence, impartiality, objectivity and prudence. In addition to moral considerations, trustees are also required to comply with all relevant legislation and regulation. The current Code of Professional Conduct encourages a

deontological approach to the ethics in terms of compliance with legislation and professional guidance. However, various virtues are listed as professional requirements, suggesting that actuarial actions could be assessed through the lens of virtue ethics where there are no rules to follow. The specific virtues listed in the Code are: integrity, objectivity, confidentiality, due care, independence, scepticism, accountability, courage, reflection as well as commitment to the public interest, social responsibility, ethical business, whistle-blowing and ethical judgement. In addition, actuaries advising trustees need to consider the duties of the trustees.

10.4 A six-step ethical framework based on the actuarial control cycle for assessing decisions was developed by the authors. The first step is to recognise that the discharge of every duty is an ethical issue and to consider specifically how it is an ethical issue. The second step is to gather all information relevant to the decision and identify stakeholders affected by the decision. The third step is to consult regulation, legislation and guidance. The fourth step is to evaluate all options for the decision against five tests:

- Is it compliant with legislation, regulation and guidance?
- Does it reflect the purpose of the retirement fund?
- Is it just?
- Does it reflect the level of care required in the relationship between the trustees and the stakeholders?
- Does the decision reflect that the decision-makers possess the correct virtues?

In the fifth step, a decision is made and communicated. In the sixth step, the impact of the decision is monitored.

10.5 The case studies illustrate that, although the framework does not provide ethical solutions in their own right it assists trustees and the actuaries that advise them with the process of making an ethical decision. Due to the fact that individual perspectives and moral codes influence decision-making (Kidder, op. cit.), it is entirely possible that different trustee boards could reach different decisions using the same decision-making framework. The framework may also have application for other stakeholders working with retirement funds, such as investment managers and administrators as well as broader applications in the financial services sector.

10.6 Trustees are the ultimate decision-makers in retirement funds and may be called upon to prove that they have applied their minds in coming to their decisions. This framework provides a structured approach to ethical decision-making that takes into account the duties of trustees. With the introduction of Treating Customers Fairly requirements in retirement funds, ethical issues are becoming more pertinent. In addition, the framework may be useful for trustee training and ongoing development.

10.7 For actuaries, the framework can assist in making recommendations regarding the decision-making process and the obligations placed on them concerning their relationship

with various stakeholders. It also supports the actuary's professional duties. These include diligence in gathering all information and promoting public interest, accountability for accessible communication, and communicating the effects of risk. The ethical decision-making framework can be helpful in demonstrating the value of preserving actuarial discretion against a backdrop of increasing regulation and in the context of complex stakeholder relationships. However, thoughtlessly applying the framework would be problematic due to the ethical duties placed on actuaries. This may mean that actuaries find themselves placed under time pressure to produce solutions for clients where the ethical issues require reflection. Actuaries may thus wish to consider specifically including practical ethical training as part of their continuing professional development. Currently the only compulsory training in dealing with ethical issues, which actuaries receive upon qualification, is through the material presented at the Professionalism Course. Other ongoing training relating to ethical decision-making is offered through on-the-job training, seminars, sessional meetings and conference proceedings. However, Lowther & McMillan (op. cit.) recognise that what is available to actuaries is insufficient. The framework presented in this paper can be applied in terms of planning for lifelong professionalisation for actuaries. The authors believe that this framework should be added to the material prescribed to newly qualified and experienced actuaries, together with the collective experience of their forebears who have faced their own ethical challenges.

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