Technical Discussion Paper C for public comment

Preservation, portability and governance for retirement funds

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1. Introduction

This paper is part of a series of technical discussion papers following the publication of the overview paper *Strengthening Retirement Savings*. This paper summarises the 2012 Budget announcements by the Minister of Finance on promoting household savings and reforming the retirement industry.

Preservation, portability and governance for retirement funds is an overview of the current preservation requirements in South African retirement funds, and presents several options for consideration by key stakeholders, including workers, employers, retirement fund members and Government. The consultation process for these options will include NEDLAC, which will have a key role to play in building wider consensus for the way forward. Draft proposals will only be made after the consultation process is completed, and will take account of accrued or vested rights. Other issues considered in this paper are retirement fund governance, the portability of benefits between funds, and annuitisation of provident fund benefits.

Other more technical papers to be released within the next two months include papers on retirement costs, the uniform tax treatment of retirement funds, and on tax-incentivised savings vehicles. All the papers will be available on the National Treasury website www.treasury.gov.za.

Executive summary

Most South Africans do not save adequately for retirement and only about half the country's workers belong to a retirement fund.

Preservation occurs when money saved for retirement through pension, provident and preservation funds remains in those funds until the person retires, or is rolled over into another similar retirement savings vehicle without incurring taxes or penalties when a person changes jobs.

Retirement savings, for the average worker, are the single largest source of income post retirement. However, rates of preservation are very low. Cashing out accumulated retirement savings prematurely erodes security in old age, undermines the alleviation of chronic poverty and increases reliance on others. This paper proposes various options to increase rates of preservation in recognition of the need to protect retirement savings from being misused due to lack of foresight and long term planning when members leave employers prior to retirement, or when non-member spouses receive cash pay-outs at the instance of divorce order settlements.

Retirement funds will be required to nudge members to save for the long-term, through the creation of appropriate defaults biased towards saving. For example, all retirement funds will be required to create a preservation fund section and to transfer funds into that section when a member leaves employment, unless the member has

indicated otherwise (e.g. to withdraw their pension in cash). Also, members who want to withdraw funds should be required to first seek advice. A more significant default could be considered, for example, to make membership to a retirement fund an automatic default, through auto-enrolment, for all those in formal employment. Government currently also has a system of tax incentives to encourage working South Africans to save for their retirement.

Government emphasises that whatever final policy is chosen, accrued or vested rights will be protected. What this means is that all funds held in retirement funds on the date of implementation of the preservation legislation will be subject to the current rules allowing access to funds on resignation or withdrawal. This paper therefore, proposes a new dispensation to increase rates of preservation for new employees joining funds after implementation of the legislation, new contributions by existing employees, and growth on existing assets. These will be subject to the new dispensation after an appropriate phasing-in period.

A withdrawal mechanism could still apply to retrenched individuals, who will be allowed to withdraw sufficient funds. This provision could be extended to pre-retirement access to savings in retirement annuity and preservation funds.

Pre-retirement preservation options for new contributions and growth

The following options, after further consultation with key stakeholders, could apply after implementation of preservation legislation to new contributions by existing employees and growth on existing assets. These will also apply to new employees joining funds.

Full withdrawal with an adjusted tax threshold

Allow full access to funds when leaving employment, but levy a tax on withdrawal above current levels, which would act as a disincentive for people to withdraw.

Three-to-five year default monitoring period

Rather than making any changes to preservation requirements now, the response of individuals to new default arrangements described above could be monitored closely for a period of three to five years. If there is no improvement in preservation rates, the issue could be revisited then.

Partial withdrawal

Permit partial (e.g. one-third) access to a cash lump sum before reaching retirement, but require preservation of the remainder.

Maximum income per month

Withdrawal of a certain amount each month could be permitted if individuals are unable to find new employment.

Full preservation

Require full preservation and allow no withdrawals of growth on existing assets, or new contributions by new or existing employees.

It should be noted that apart from the above options, greater portability between pension funds should be encouraged. Portability refers to an employee's ability to transfer accumulated retirement savings to a prospective employer's pension fund, transfer to a preservation fund with a financial institution or leave retirement savings with their former employers when changing jobs. All funds will be required to accept transfers of the accumulated funds of new workers from previous employers when they join.

Provident and pension fund alignment

The problem of insufficient retirement provision is not only a result of pre-retirement withdrawals but also the consequence of lump sum pay-outs made from provident funds at retirement. The lack of annuitisation in provident funds means that many retirees may spend their retirement assets too quickly, and face the risk of outliving their retirement savings. Aligning the retirement benefits of provident funds to those of pension and retirement annuity funds will help retirees from provident funds to better manage longevity risk and investment risk, and prevent them from spending their retirement assets too quickly and becoming reliant on the state or their families for support. Further, it will also allow members of provident funds to enjoy the same tax deduction on their own contributions as currently applied to contributions by pension fund members.

Three options for the alignment are presented for consultation with regards to provident fund benefits at retirement.

Maintain status quo

The first option is to permit individuals retiring from provident funds to access their funds under the current dispensation, so no new changes are adopted, and the status quo continues. Further creation of provident funds would however, not be allowed, following the harmonisation of the tax treatment of contributions to retirement funds.

Access to nominal value of accumulated savings

The second option preserves vested rights by allowing the value of the fund credit accrued on the day of the implementation of the legislation to be paid out as a lump sum on retirement. Growth on this amount, and new contributions, will be subject to the same rules governing the retirement benefits of pension funds. A *de minimus* rule will be considered for accumulated amounts that may not be practical to preserve.

Phased withdrawal

A third approach is to adopt a vesting scale system that will allow employees aged 50 and upwards, at the date of implementation of the legislation, to take a larger portion of their retirement savings as

cash lump sum at retirement. Provident fund members who are less than the age of 50 at the date of implementation of legislative changes will be subject to provisions applicable to pension fund members.

Pension fund governance

The role of trustees is an important aspect of pension fund governance. However, it is widely acknowledged that many trustees may lack the competence and necessary skills to make investment and management decisions consistent with the best interest of beneficiaries. As a result, Government is considering empowering trustees through compulsory (and regular) training requirements, and reinforcing good governance principles. Further, it is proposed that certain Financial Services Board Circulars on governance (i.e. PF circular 130) be elevated to a directive status.

2. Background

About this paper

Preservation, portability and governance for retirement funds forms part of a series of discussion papers on promoting household savings and reforming the retirement industry, as described in a recent National Treasury publication titled *Strengthening retirement savings: An overview of proposals announced in the 2012 Budget*. The need for such reforms is obvious: most South Africans do not save adequately for retirement and only about half the country's workers belong to a retirement fund.

Government is committed to increasing the financial security of all citizens. To realise this, wide-ranging proposals to reform social security and retirement funds are being considered. The goal is a fair and sustainable social security system, supported by a mandatory statutory fund that provides pension, life insurance and disability benefits. Within this framework, additional savings will be encouraged in approved retirement funds for those earning above the ceiling established for the national fund.

This paper discusses preservation on job changes and divorce settlement orders, and harmonising annuitisation requirements. The aim is to strengthen retirement security, long-term savings and pension fund governance.

The paper reviews the current regime for private pensions and the state of long-term savings. This paper presents a system of portability and various options to increase the rate of preservation and reduce pre-retirement leakages (that is, pension funds diminishing before retirement) and therefore enhance retirement savings. Preservation keeps intact pension and other retirement savings. Portability enables employees changing jobs to transfer accumulated pension benefits to the prospective employer's plan or to a preservation fund, or to leave retirement savings with their former employer.

Further, to deal with the problem of post-retirement leakage (that is, pension savings diminishing after retirement), this paper also raises the question as to whether benefits from provident funds should not be treated in the same way as benefits from pension and retirement annuity funds, while giving consideration to protecting vested rights. Lastly, this paper discusses using existing measures to ensure that trustees are sufficiently trained and adhere to good governance principles within a certain period of being appointed.

South Africa has one of the largest retirement fund industries in the world relative to GDP. The total assets of private sector pension funds exceed R1 trillion and total about R2.4 trillion if the Government Employees Pension Fund (GEPF) is included. In all there are 9 million pension fund members (10.3 million including the GEPF) representing around 6 million workers. Globally and locally, retirement funds are important institutional investors that pool funds

from employers and employees, with the aim of providing retirees and or their beneficiaries with income when a member retires, dies or is disabled. This consumption smoothing effect[1] of retirement funds fulfills the important social objective of lessening poverty in old age and dependence on the state and family members in old age.

National Treasury's discussion document, *"A safer financial sector to serve South Africa better",* acknowledges the increasingly critical role pension funds play in providing more sustainable and secure benefits, while ensuring that income needs in old age are adequately met. According to the document,

"*Pension funds play an important role in the national economy. Given South Africa's low savings rate and the present twin fiscal and current account deficits, pensions are even more important for economic development. Pension funds, smartly invested, provide a mechanism for unlocking savings, stimulating economic growth and ensuring that pensioners are provided for in retirement."*

The Budget Review 2011 also touches on the growing need to reform the retirement funding industry. It states:

"*Coverage of occupational funds in South Africa is high relative to other countries of similar income level, though coverage varies across sectors and households generally do not save adequately for retirement. A key reason for the disparity in coverage levels and savings rates is the lack of preservation, resulting in workers often liquidating their savings when they leave a job rather than transfer them to a new fund".*

At the tenth anniversary of the South African Savings Institute and the launch of Savings Month (July 2011), the Minister of Finance pointed out South Africa's dismal savings rate compared with other countries. Government recognises that much needs to be done to tackle the problem of low savings.

[1] **Consumption smoothing** is the economic concept used to express the desire for people to have a stable path of consumption.

3. The role of retirement funds in a South African context

Retirement funds have evolved in response to three economic factors:

- Individuals use retirement funds to facilitate life cycle savings, thereby smoothing consumption over their lives.
- Institutional features of retirement funds manage systematic irrationality by individuals in savings and investment behaviour.
- Government gives substantial tax incentives to individuals to save through their retirement funds, because higher savings enhance individual security, reducing potential reliance on the state. Further, increased domestic savings allows greater investment in the economy and enhances economic growth while protecting financial stability.

Pensions and savings

Economists use a basic framework, the Life Cycle / Permanent Income Hypothesis, to understand individual savings across people's lives. The hypothesis states that because people prefer smooth consumption, though with fluctuating incomes, they choose to spend a constant proportion of their lifetime income, borrowing when actual income is below this level, and saving when it is higher.

Typically, incomes are low when people are young, higher in middle age and low again when individuals retire and move out of the labour market. The life cycle hypothesis predicts that the average tendency to consume out of income is greater for both young and aging individuals, since the young borrow against future income (often to buy homes), and the old use accumulated savings to finance consumption, thus reducing their pensions. Middle-aged people have a greater propensity to save and a lower propensity to consume out of income.

The hypothesis says little, however, about the economic institutions that act as agents for these savings. Retirement funds are designed primarily to promote life-cycle savings, and encourage individuals to save while working to finance consumption after retirement.

Besides consumption smoothing, there are other motivations for people to save. They may save for precautionary motives – for instance because they fear unemployment or the expenses associated with illness. They may also save to build up spending power – most importantly to buy a house, but also to buy cars or to plan for weddings and funerals. Finally, they may save in order to bequeath assets to future generations.

To some extent, pension funds are allowed to fulfil these savings functions as well. It is currently permissible for South Africans to

borrow from their retirement funds in order to purchase a house, and it is common for pension funds to provide life and disability protection to their members.

There are sound economic reasons for pension funds to be used in this way– economies of scale in administration, group risk pooling that protects insurers against adverse selection, and positive externalities (benefit "spill-over" to a party that was not a part of the original transaction or decision making process) associated with the presence of the employer, to name a few. Although Government encourages pension funds to provide members with cost-effective risk benefits, it views the main role of pension funds as making possible life cycle savings to support consumption in retirement.

South African law allows individuals leaving pension and provident funds on job changes to access their entire retirement balances in cash, although tax is payable on the withdrawal of a lump sum benefit pre-retirement. In addition, non-member spouses may receive cash payments in the case of divorce orders. These lump sum cash payouts are possible for both defined benefit and defined contribution funds. Such payouts cannot be considered life cycle savings if they are received before the retirement fund member reaches retirement age. This problem of leakage is a significant weakness in the retirement provision system and also has major negative implications for the country's long-term savings. Unfortunately it is also quite prevalent, especially among the young.

For instance, according to the 2011 Sanlam Benchmark Survey, 107 members out of 152 (70 per cent) who left retirement funds through resignation or retrenchment withdrew from retirement funds, 9 per cent preserved part of the benefit while taking the rest in cash, and only 2 per cent moved the benefit to the prospective employer's fund (see Table 1 below).

Table 1 Premature Use of Retirement Fund Benefits

	2011		2010	
	TOTAL	%	TOTAL	%
BASE: ALL RESPONDENTS	**152**	100	141	100
I withdrew the full benefit in cash	**107**	70	93	66
Preserved part of the benefit and took the rest in cash	**14**	9	22	16
Moved the entire benefit to another employer's fund	**3**	2	5	4
Purchased an annuity with the benefit	**9**	6	15	10
Purchased unit trusts with the benefit	**2**	1	2	1
Other	**4**	3	2	1
Don't know	**1**	1	1	1

Source: Sanlam Benchmark Survey, 2011

Of those who cashed their benefits, 36 per cent reduced short-term debt, while 29 per cent settled or reduced their mortgages. Although debt reduction is important, it defeats the aim of pension funds in cases where members increase borrowing because they expect to repay debt by accessing their pension funds.

Systematic irrationality

A second important feature of retirement funds is that they manage systematic irrationality on the part of individuals. There is substantial international academic evidence that individuals are poor long-term planners when it comes to pensions and savings. They often undervalue the future relative to the present, and therefore over-consume while they are working, only to find that they cannot afford to retire or must limit their consumption when they do. In addition, individuals often make poor investment choices. They choose investment products with high fees where similar, cheaper products are available, they exhibit substantial inertia in investment and savings decisions, and they are heavily influenced by how asset allocation and contribution decisions are framed. There is no reason to believe that South Africans are different.

Many institutional features of South African pension funds are designed to encourage individuals to save for the long term even though they might be poor decision-makers. Pension fund membership is usually a condition of employment; the fund sets minimum contributions; contributions are deducted from gross salaries; and a board of trustees rather than individual fund members often makes retirement fund investment decisions. A glaring omission in law is that preserving retirement assets on change of job is not mandatory.

Individuals who cash out and spend their accumulated retirement savings are likely to suffer financial insecurity later in life. A high fraction of lump sum cash payouts occurs when individuals change jobs early in their careers. Such early withdrawals give up the opportunity and significant benefits of compound accumulation at pretax rates of return. Most members do not have sufficient discretionary income from which to make the requisite level of retirement savings later in life to compensate for the total accumulated and compounded retirement savings forfeited. Unlike many other provisions of the pension system, the current policy on pre-retirement withdrawals appears to encourage economic myopia, rather than trying to mitigate its effects.

Savings and investment

Investment in physical and human capital is one of the major sources of economic growth. Investment and economic growth tend to be strongly correlated, and growth models predict a positive response of growth to investment.[2] Investment requires savings, from either domestic or foreign sources. Foreign savings, and therefore inflows, can be an important source for domestic investment, but in the long run an economy cannot entirely rely on foreign investment, especially where it is short term in nature. Portfolio inflows have a tendency to reverse quickly and cause shocks, especially in relatively small or emerging economies. Domestic savings therefore need to be mobilised to finance economic growth.

[2] Harjes, T. and Ricci, L.A. (2006). *What drives saving in South Africa?*

The World Bank (2011) also noted that in light of South Africa's low national savings, the biggest cause for macroeconomic volatility over the medium term would be the re-emergence of high current account deficits, financed mostly through volatile portfolio flows. The crises in the United States and the Eurozone show also that large and prolonged current account deficit can pose serious problems for policy makers.

What journalists and experts say …

A shocking 81 per cent of retirement fund members will retire with pensions that will in no way be sufficient for them to sustain their pre-retirement lifestyle.

… The research shows that most retirement fund members start off well when they begin working but, as they get older, they increasingly fall off the secure retirement bus.

Most retirement funds aim at providing a net replacement ratio (NRR) of between 75 and 80 per cent after 35 to 40 years of fund membership. A NRR is the percentage of final pensionable salary (basic salary without perks such as travel allowance or an annual bonus) that will be received as a pension.

A NRR of 75 per cent assumes that one will have little or no debt when they retire and that lower living expenses will be incurred during retirement compared to pre-retirement.

A NRR of 60 per cent is generally considered the absolute minimum, below it one is not going to come anywhere close to maintaining pre-retirement lifestyle. And if one takes one-third of retirement savings in cash, the NRR is further reduced.

Bruce Cameron, 17 January 2011, *Personal Finance*

An individual who changes jobs three or more times in his or her working life and withdraws 50 per cent of his retirement benefit each time, will reach retirement with a replacement ratio of only 30 per cent.

Why preserve? Withdrawing your retirement benefits reduces the capital amount available at retirement. Rather than withdrawing your benefits as cash, you should transfer them from your current employer's pension or provident fund to a pension preservation fund, provident preservation fund or a retirement annuity (RA).

Gareth Stokes, 23 April 2010, *Mail & Guardian*

Only 53 per cent of employed metropolitan South Africans contribute to a pension or provident fund to save for their retirement. Deduct those who contribute to a retirement annuity and almost 40 per cent of the formally employed have no retirement savings. And these are not just lower income earners. Around 16 per cent of people earning R40 000 per household have no pension.

Sasha Planting, 20 July 2011, Moneyweb

A lack of awareness around personal retirement savings and contributions to retirement schemes is one of the key reasons why the majority of working South Africans are not saving enough for retirement. Preservation is an area of retirement funding that requires urgent attention and focus. It needs to be made easier and more compelling for fund members to preserve their benefits.

Gregg Gordon, 30 July 2011, Business Times

South Africa has experienced a steady decline in its national savings rate over the past several decades, which has been accompanied by a

fall in domestic investment. The savings rate in 2010, net of depreciation, reached 3.2 per cent of Gross Domestic Product (GDP). Net corporate savings were 7.8 per cent of GDP, while savings by households and the Government were negative 0.2 per cent and negative 4.4 per cent of GDP (i.e. dissaving), respectively.

A study by the World Bank in 2011 shows that eight emerging economies, which grew by an annual average of at least 6 per cent between 1980 and 2008, had a simple average saving rate of 31 per cent of GDP, with China at 40 per cent, India at 23.4 per cent, and Botswana and Malaysia both at 38 per cent. South Africa can achieve this gross saving rate of 31 per cent, given that in 1980 it had a saving rate of 33.6 per cent. Although higher savings and investment alone might not suffice, the World Bank study argues that South Africa must at least increase investment and savings if it intends to grow the economy and create jobs.

Retirement fund assets are a crucial feature of South Africa's savings architecture. If savings from employers and employees are properly invested, pension funds can play an important role in economic development, particularly since they are globally important institutional investors. Retirement funds and other institutional investors have a positive impact on economic development and growth given their long-term investment horizon and investment in less liquid, long-term assets such as infrastructure and venture capital.[3] If members were to invest for the long term, rather than cash out retirement savings at every change of job, retirement funds would more easily be able to achieve their potential of contributing towards direct capital formation, which requires long-term saving.

While there may be some double counting, particularly between the retirement fund and long term insurance sectors, pension funds controlled at least 22 per cent of the assets under management of the South African financial sector in 2010, and long-term insurers a further 21 per cent, much of which may represent retirement savings. According to an analysis performed for Treasury, more than half of household savings between 1999 and 2010 flowed into retirement funds and long-term insurers.

Government already gives substantial tax incentives to individuals to save through their retirement funds, both before and after retirement. Although increasing the savings rate of South African households undoubtedly requires policy changes affecting more than just pensions, it is clear that policy changes to increase pension saving will be crucial.

Further, there is the effect that pre-retirement withdrawals have on the composition of pension fund portfolios. Although preservation may still require funds to hold investments in liquid portfolios, the current environment, which lacks mandatory preservation, may cause pension funds to hold more liquid portfolios funds to meet the

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[3] OECD Discussion Note. EUROFI High Level Seminar 2011. *Promoting longer-term investment by institutional investors: Selected issues and policies.*

demands of pre-retirement withdrawals. Liquid portfolios tend to have lower returns. Mandatory preservation may therefore increase the availability of funds for long-term investment.

In response to rising costs, many countries have taken steps towards reforming their old-age social insurance systems. A widespread change has been to increase the age at which employees become eligible for pension benefits. To further enhance retirement savings, many countries have opted to make occupational pension funds mandatory. Across the world, funded occupational pension plans play an important and growing role in providing for old age.

Regardless of any legislative change, South Africans will still require extensive education on preserving their savings for retirement. Only about 6 per cent of retired people are in a position to maintain their pre-retirement living standards post-retirement.[4] The 2011 Sanlam Benchmark Survey indicates that most people interviewed preferred being forced to save, providing a strong case for a paternalistic approach towards retirement savings. A significant 81 per cent of the sample of 754 active members of retirement funds said that they would not opt out of mandatory contributions if given the choice.

[4] Peet Strydom. (2007). *Saving Behaviour by South African households.*

4. Addressing pre-retirement leakages and preservation

This paper proposes measures to reduce pre-retirement leakages by increasing rates of preservation, as well as increasing the portability of benefits between funds. A withdrawal mechanism could still apply to retrenched individuals, who will be allowed to withdraw sufficient funds. This provision could be extended to pre-retirement access to savings in retirement annuity and preservation funds.

Increasing preservation

Preservation is the requirement that money saved for retirement through a pension fund or provident fund remains in such a fund until retirement, or is rolled over into another similar retirement savings vehicle without incurring taxes or penalties when a person changes jobs (that is, it has portability).

Table 2 below illustrates the preservation and annuitisation rules applicable at present to South African retirement funds, before and after retirement.

Table 2 Retirement Fund Rules

Retirement Annuity	Before age 55, all retirement benefits must be preserved.	After age 55, at least 2/3 of the retirement benefit must be annuitised, and the balance can be taken as a lump sum.
Pension Fund	Before retirement, funds can be accessed when members change jobs, are retrenched, or in the case of divorce order. Members may also borrow, either from the fund or using the fund as collateral, to purchase a house.	After retirement, at least 2/3 of the retirement benefit must be annuitised, and the balance can be taken as a lump sum.
Provident Fund	Before retirement, funds can be accessed when members change jobs, are retrenched, or in the case of divorce order. Members may also borrow, either from the fund or using the fund as collateral, to purchase a house.	After retirement, annuitisation is completely voluntary.
Preservation Fund	Individuals are permitted one cash withdrawal pre-retirement. Exceptions are if this is not permitted by the prior Fund rules, or if a prior withdrawal was made (such as in the case of a home loan or divorce order).	At retirement, the pension fund or provident fund rules apply, according to which type of fund the assets originally derived.

There is an uneven treatment of retirement savings products in South Africa. For instance, the anecdotal cases of employees resigning to access retirement savings from pension and provident funds can be ascribed to the absence of preservation. At the other end of the spectrum, those using retirement annuity funds are barred from withdrawing their savings even in cases of financial hardship. This disparity shows the need to ensure consistent treatment of products.

The 2012 Budget moots the introduction of preservation. Preservation would be triggered when pension and provident fund members leave their funds by changing jobs. To lessen the impact on current workers who may view their retirement savings as precautionary or medium-term consumption smoothing, and to prevent any short-term disruption to retirement savings, vested rights of workers will be protected.

There is no intention to alter the provisions that currently allow individuals to borrow from their retirement funds or to use them as collateral for a loan that they might use to buy a house.

Mandatory preservation of retirement savings is very common throughout the world (see box below). For example, Australia, Chile, Switzerland and Germany insist on it. The United Kingdom and Canada require mandatory preservation, but exempt employees who have belonged to pension schemes for less than two years when they leave their jobs. A notable exception is the United States, where employees may withdraw their retirement benefits at any time, although withdrawals are taxed as earned income, and attract a further tax penalty of 10 per cent.

International experience with preservation and portability

Germany: Upon termination of employment before retirement, the member's accrued benefits or accumulated capital may either be preserved in the previous employer's plan or transferred to the plan of the new employer.

Switzerland: Upon termination of membership with a pension institution before retirement, disability or death, occupational fund members are entitled to their vested benefit. This is generally paid to the pension institution of the new employer. Members may, however, receive the vested benefit as a cash lump sum if they establish an independent business and are no longer covered by a mandatory occupational plan, leave Switzerland, or the vested benefit amounts to less than their annual contribution.

Canada and United Kingdom: Similar pension benefit systems exist in that occupational pension rights vest after two years of pensionable service. Early leavers with vested benefits can preserve accrued benefits in the previous pension scheme, transfer to a new occupational pension scheme, or transfer to a personal pension. Pre-retirement withdrawals are prohibited in both.

United States: There is no preservation of pension benefits, although there is a tax disincentive to withdraw funds from retirement vehicles before retirement. Pre-retirement distributions are therefore common, which is not surprising, given that most employees receive much of their retirement income in the form of social security payments rather than from private sector pensions. Portability is only possible if there is a reciprocity agreement between employer plans.

Australia: Preservation of contributions is mandatory up to the age of 55 and benefits are fully portable

Options for increasing preservation

It is proposed that full protection be granted to accrued or vested rights. This means that on the date of implementation of the legislation, all balances accrued will be subject to current rules. This will apply regardless of whether these balances remain in the current fund, or are transferred to new occupational funds. This means that existing employees changing jobs will thus have access to the

nominal value of retirement savings accumulated on date of implementation of the legislation.

However, growth on these assets, new contributions by existing members and the contributions of new members will be subject to the new dispensation. A number of options are presented for further consultation with key stakeholders on the treatment of these contributions and growth.

Although the stated intention is to protect retirement savings through a system of preservation and portability, it is also recognised that there might be a need to allow access to accumulated retirement savings in certain limited instances. This is especially important in South Africa, where a social safety net is not yet in place for formally employed middle-income employees.

Leakage is particularly difficult to address given the South African economy's structural problems. South Africa has a high unemployment rate, at present 25.2 per cent if narrowly defined.[5] Unemployment benefits through the Unemployment Insurance Fund (UIF) are restricted to those previously employed, and are payable for up to eight months only. Consequently, the retrenched typically rely on pension funds to survive until they find another job. A withdrawal mechanism could still apply to retrenched individuals, who will be allowed to withdraw sufficient funds. This provision could be extended to pre-retirement access to savings in retirement annuity and preservation funds.

It is proposed that all pension funds should be required to create a preservation section within the fund and, as the default option, transfer funds to a preservation fund when a member leaves employment, unless the member has indicated otherwise (e.g. to withdraw their pension in cash). Moreover, members who opt to withdraw funds should be required to first seek advice.

The following options are proposed for new contributions by new employees joining funds after implementation of the legislation, new contributions by existing employees, and growth on existing assets:

Options for new employees/contributions/growth

Full withdrawal with an adjusted tax threshold

This option allows funds to be withdrawn on resignation, albeit with a higher tax on pre-retirement withdrawals to act as a disincentive.

Three-to-five year default monitoring period

This option allows for a certain period (three or five years) for monitoring the default arrangement. The default arrangement requires employees changing jobs to be defaulted into a preservation fund, unless they elect to withdraw. Further, an election to withdraw should be made after having sought advice. The monitoring period will therefore call for a stricter approach, which could include

[5] Quarterly Labour Force Survey, Quarter 1, 2012. Statistics South Africa.

introducing new legislation, to be implemented, if there is no noticeable change in behavior (i.e. increased preservation).

Partial withdrawal

This option would allow access to a maximum of one-third of accumulated savings. All withdrawals will be taxable at the rates prescribed by the Income Tax Act and will be cumulative up to the one-third.

A maximum income per month

This option would allow access to a certain amount per month. Possible values are the lesser of R5 000 or 3 per cent of the fund's accumulated balance per month.

Full preservation

This option requires full preservation of new contributions and to allow no withdrawals pre-retirement.

Examples of the options on increased preservation

Voluntary withdrawal

Thabo has been a member of the Mining Retirement Fund for 6 years. On the date the legislative amendments requiring increased preservation come into effect, he has R75 000 in the fund.

Over the next three years, the R75 000 has grown to R100 000 as a result of new contributions and growth. He then leaves his employer voluntarily.

Increased taxes on withdrawal:

Under this option, he will be allowed to take out the whole R100 000. However, under current tax rates, he would pay R13 950 in tax on the withdrawal. Under new, higher tax rates, he may pay R18 000 in tax. He therefore keeps R82 000.

Two-thirds preservation:

Under this option, he will be allowed to take the full R75 000 since vested rights on this money were protected. However, on the R25 000 growth, he would only be permitted to take one-third, which is R8 333. He is therefore permitted to take R75 000 + R 8 333 = R83 333. He would pay tax according to the then-prevailing withdrawal tax scales on this amount. The tax on this amount would, under current tax rates, be R15 000. He therefore takes R68 333. The remaining R16 666 he would be required to preserve in the fund, or take to a new fund.

A regular monthly income:

Under this option, he will be allowed to take the full R75 000 since vested rights on this money were protected. However, on the R25 000 growth, he would only be permitted to take a regular income of the lesser of 3% of the fund (R750) or R5 000 per month. The remainder he would be required to leave in the fund, or take to a new fund. He would be required to pay the appropriate tax on the monthly withdrawals.

Full preservation:

Under this option, he will be allowed to take the full R75 000 since vested rights on this money were protected. However, he would not be allowed to take any of the R25 000 and must preserve the whole amount in the fund, or in a new fund.

Portability and better defaults

To effectively enable preservation, the 2012 Budget also proposed that portability of pension benefits be provided for. Portability allows employees changing jobs to transfer accumulated pension benefits to their prospective employer’s plan or to a preservation fund, or to leave retirement savings with their former employer.

Employees hold numerous jobs during their working lives. Employees who change jobs and opt for a cash pay-out when doing so often end up with lower accumulated retirement benefits than employees who remain with one employer or employees who preserve retirement benefits when changing jobs. A portable pension ties pensions to individuals instead of to jobs.

Although pension funds have an option not to allow employees to leave benefits in the fund when they stop working for existing employers, many funds allow employees to do so at present. It is proposed that all funds set up a preservation fund, which allows employees to leave their balances in the retirement fund when they resign or are retrenched (the latter, if they choose to preserve). Further, it is suggested that withdrawing member’s balances be automatically shifted into that section unless members request

otherwise. Funds may have the option not to permit further contributions.

Funds must also incorporate into their rules a provision to accept transfers of accumulated balances by new employees, should an employee elect to transfer accumulated pension savings to the prospective employer's fund. This provision may be difficult for open defined benefit funds and may leave employees vulnerable to exploitation because the fund must specify the terms on which the transfer should take place. It is therefore, proposed that open defined benefit funds be exempt from this provision. Instead, employees who join employers with such pension funds may be required to transfer their accumulated balances into a preservation fund or a Retirement Annuity fund. Given that few open defined benefit funds remain in the private sector, it is not anticipated that this exemption will be onerous. The options described in this section should apply to pension funds, provident funds and retirement annuity funds. This will substantially simplify the retirement system, allowing individuals to merge their different pension accounts, and significantly reduce costs.

Auto-enrolment

A complementary option to consider will be to nudge or oblige all formal employers to ensure that their employees join a retirement fund. This approach is in line with the current approach in many countries, where there is an obligation on all employees to join such a fund. This option could also be considered to complement the options presented above on preservation. Though this paper does not go into this option, it is an option that stakeholders, including NEDLAC, should consider when engaging with the options on preservation.

5. Post-retirement leakages and annuitisation

Another technical discussion paper titled: *Enabling a better income in retirement*, reviews the annuities market and presents some possible options for reform. However, currently, annuitisation requirements only apply to members of pension funds and retirement annuity funds. This section examines how these proposed annuitisation requirements could be extended to provident funds.

Inadequate retirement provision is exacerbated when members of provident funds take lump-sum payouts on retirement. In the absence of annuitisation requirements, many members may spend down these assets quickly, being forced to rely on the state or family members to support their consumption thereafter.

Individuals and households need to manage their post-retirement assets to provide an income for the rest of their lifetime. After retirement, retirees and their families face many risks. The biggest risk is that they might outlive retirement savings (longevity risk) or that retirement assets could underperform (investment risk) – or both. These two major risks are inherent in defined contribution funds and living annuities. Longevity risk can be pooled through guaranteed annuities, but it seems that few retiring employees elect such annuities. The lack of annuitisation is more pronounced in provident funds because they pay out only once-off cash lump sums.

A life annuity is a series of payments over time, designed to eliminate longevity risk by allowing an individual to exchange a lump sum of wealth for income payments that continue as long as the individual – and in the case of a reversionary annuity[6], the spouse – is alive. In particular, life annuities can substantially increase individuals' welfare by eliminating the financial risks associated with uncertain lifetimes, unknown future inflation and investment risk.

A major concern with provident funds has been the post-retirement leakage caused by the full cash lump sum benefit payable to a retiring member. This is in contrast to pension and retirement annuity funds, which make it compulsory for a member to convert at least two-thirds into an annuity on retirement. Though provident funds were developed for the primary purpose of providing a cash lump sum upon retirement rather than a monthly pension, there is also a need and rationale to encourage people to use their retirement benefit to purchase an annuity.[7]

Attitudes towards compulsory annuitisation

[6] Reversionary annuity is a retirement income strategy that combines an insurance policy with an immediate annuity to provide for a surviving spouse. Upon the insured's or annuitant's death, the beneficiary receives a guaranteed lifetime income instead of a lump sum payment.

[7] Dewar *et al.* (2005). *The practical guide to retirement funds and retirement planning 2005-2006.*

The 17 provident fund respondents hold mixed views on compulsory annuitisation with 7 strongly in favour, 3 somewhat in favour, 2 not in favour, and 3 only in favour if funds can be accessed in emergencies.

The Umbrella provident fund representatives had mixed views on compulsory annuitisation with 5 strongly in favour, 3 somewhat in favour, 2 not in favour and 3 only in favour if funds can be accessed in emergencies.

Old Mutual Retirement Funds Survey 2008, Examining trends, attitudes and perceptions in the retirement funds industry.

Persuading provident fund members to annuitise a portion of their benefit poses certain challenges. For example, employees said they preferred provident funds to defined benefit funds, which they mistrusted. Historically, many pension funds were defined benefit in nature, and the withdrawal benefits of defined benefit funds paid employees only their member contributions when changing jobs, whereas provident funds were generally defined contribution funds, and so had some enhanced transparency. In addition, lump sums were seen as cost-effective compared to annuities.

Aligning provident and pension funds

The current approach of allowing employees to opt for either a pension or provident fund results in a two-tier system, where one set of employees take advantage of the tax contribution deduction on their own contributions, while the other set of employees do not have this advantage. Whilst there is a trade-off between taking up the contribution tax deduction and annuitisation, many employees are not aware of this trade-off, and hence not fully informed when deciding to join a pension or provident fund. This choice is also a consequence of labour struggles in the 1980s, as many workers were denied adequate retirement options as part of their remuneration package. This choice is also one between low-income and higher-income employees, with low-income employees largely joining provident funds, whilst higher-income employees join pension funds.

In a post-apartheid democratic South Africa, the question does arise as to whether there are still grounds to differentiate between the two different types of retirement funds, and whether the system should not be harmonised into one type of retirement fund. Should this approach be considered, there would be a need to protect the vested rights of provident fund members by allowing balances accrued at the date of implementation of the legislation to be taken as lump sums on retirement. The first option is therefore, to permit individuals retiring from provident funds to access their funds under the current dispensation, so no new changes are adopted, and the status quo continues.

A second option towards aligning provident and pension fund benefits is for any growth on provident fund assets and new contributions post implementation of legislation, to be subject to the rules applicable to pension funds and retirement annuities. The *de*

minimus rule could also be increased from the current R75 000 to accommodate those retiring with small balances as well as growth amounts that are not feasible to annuitise. If this approach is followed, the effect on members of provident funds would be small for many years.

A last option is to adopt a vesting rule similar to that shown in Table 3 to allow for a smooth transition.

Table 3 Proposed Annuitisation requirement for Provident Funds

Years to retirement*	Cash: 1/3+	Annuity
10	0% of 2/3 full cash	100% of 2/3rds
9	10% of 2/3 full cash	90% of 2/3rds
8	20% of 2/3 full cash	80% of 2/3rds
7	30% of 2/3 full cash	70% of 2/3rds
6	40% of 2/3 full cash	60% of 2/3rds
5	50% of 2/3 full cash	50% of 2/3rds
4	60% of 2/3 full cash	40% of 2/3rds
3	70% of 2/3 full cash	30% of 2/3rds
2	80% of 2/3 full cash	20% of 2/3rds
1	90% of 2/3 full cash	10% of 2/3rds
0	100% of 2/3 full cash	0% of 2/3rds

*Years to retirement at date of implementation of legislation.

The proposal to phase in changes to the withdrawal of provident fund benefits seeks to protect vested rights for members of provident funds aged 50 and above at the date of implementation of the legislation. The sliding scale provided allows such members to take a larger portion of their retirement savings as a lump sum at retirement if they are above the age of 50 when legislative changes occur.

The vested right to access the provident fund in cash is more protected for those aged over 50 acknowledging that people of that age probably have reasonably firm plans for retirement, and that introducing regulatory change should not disrupt sound retirement planning that has already made. Introducing the change for members younger than 50 recognises that people are unlikely to have made firm retirement plans. If they have made plans, they have enough time to modify them.

Examples of the applicability of the proposed scales in Table 3

Scenario 1:
Using 60 as a retirement age, a provident fund member aged 50 at the date of implementation of legislative changes would be 10 years from retirement. Upon retirement, such a member would be entitled to the one-third cash lump sum and zero per cent of the remaining two-thirds in cash, meaning that the two-thirds will have to be annuitised. If the same member leaves the provident fund prior to retirement age (reaching the age of 60), for whatever reason, he/she will be able to withdraw only up to the one-third in cash and have the remaining two-thirds preserved or transferred to a prospective employer.

Scenario 2:
Using 60 years as the retirement age, a provident fund member who is 45 at the date of implementation of legislative changes falls outside the additional cash benefit proposed in Table 3. Upon retirement, that is reaching the age of 60, such a member will only be entitled to the one-third cash lump sum and annuitisation of the remaining two-thirds. The 45-year-old, however, is allowed withdrawals of up to one-third of accumulated retirement savings prior to retirement without having to fulfil the conditions set for pre-retirement withdrawals for pension and retirement annuity funds as per section 4.1. The allowed one-third pre-retirement withdrawal does, however, reduce the one-third cash lump sum available upon retirement.

Scenario 3:
A person who is 60 years old at the date of implementation of legislative changes is entitled to the whole fund credit as a lump sum upon retirement (one-third cash lump sum plus a 100 per cent full cash of the remaining two-thirds). This means that the current provident funds *status quo* of taking everything as full cash lump sum benefit would be maintained for those already retiring by the time the legislative changes become effective.

In all options, the annuitisation rules applicable will be the same as those proposed for pension funds and retirement annuity holders in the document titled: *Enabling a better income in retirement*. More details on the proposals for the reform of the annuities market are given in that document.

The proposed changes to the annuitisation of provident fund benefits, in tandem with changes to the taxation of contributions to retirement funds to be discussed in a subsequent technical discussion paper, and the changes to the preservation requirements of retirement annuities and preservation funds, imply that all forms of retirement savings – pension, provident, retirement annuity and preservation funds will be harmonised. This simplification of the retirement system is an important step in reducing retirement fund costs and in removing the historical legacy of inequality and inequity in the retirement system.

6. Retirement fund governance

Policymakers around the world have robustly debated the efficacy of a retirement fund governance model which relies heavily on the expertise of pension fund trustees. In a financial world of increasing complexity that demands high levels of expertise, it is widely believed that many trustees may lack the competence to make investment decisions consistent with the best interest of beneficiaries (members).[8] Another problem is conflicts of interest in the way that trustees discharge their duties to the beneficiaries of the fund.

The 2007 PwC SA[9] survey shows that employee-elected trustees are chosen with no consideration of skills and knowledge, while employer-elected trustees are picked on the basis of appearing to have generic knowledge and skills. This disparity in skills and knowledge between employer and employee elected trustees is a concern. A 2012 PwC SA[10] survey found that 56 per cent of employer trustees and 73 per cent of professional trustees have more than 10 years' experience, compared to 13 per cent of member trustees.

In 2007, the Financial Services Board issued a Pension Funds Circular 130 on good governance for retirement funds. Circular 130 requires that trustees put in place a documented code of conduct, an investment statement, communication strategy to members, and have a performance appraisal system for trustees. It also obliges new board members to receive comprehensive training and all board members to be trained on a continuing basis.

Although the Circular extensively covers elements relevant to the sound operation, conduct, duties and obligations of boards of trustees, it is not enforceable. The non-enforceability might be a concern because the industry and trustees might voluntarily adhere to the Circular. It is Government's view that Circular 130 should be legally enforceable by the Registrar of Pension Funds, and therefore attain the status of a regulation that would be rigorously applied and complied with by boards of trustees.

The Financial Services Board has also launched an online education programme, known as the Trustee Toolkit, for the development and education of retirement fund trustees. The Toolkit is voluntary and may also serve as a useful reference for trustees, administrators of retirement funds, and anyone interested in retirement fund governance and management. The Toolkit is structured along the lines of the Pension Funds Circular 130 (that is, governance by the board, governance of operations of funds, and management of stakeholder relationships), thus reinforcing the importance of good governance.

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[8] G.L. Clark, E. Caerlewy-Smith and J.C. Marshall. (2005) *Pension fund trustee competence: decision-making in problems relevant to investment practice.*

[9] Price WaterHouse Coopers South Africa. (2007) *Survey on effective management of South African retirement funds.*

[10] Price WaterHouse Coopers South Africa. (2012) *Today's decisions, tomorrow's rewards: Retirement fund strategic matters and remuneration survey.*

Policy proposals

For pension fund governance to be effective, suitability standards are essential to ensure integrity and professionalism in managing pension funds. Given the pivotal fiduciary role that trustees play, it is critical that they have appropriate professional qualifications and experience to deal with the complexities surrounding pension funds.

Government is therefore considering making it a statutory requirement that trustees be "fit and proper", with relevant qualifications and expertise in the management of pension funds. This will require that trustees undergo some form of training to ensure that they are empowered with the requisite skills and information to carry out their duties continually and consistently. Given that governance guidelines and educational material are already in place, the proposal is that the Pension Funds Circular 130 and the Trustee Toolkit be elevated respectively into legally enforceable governance and training instruments.

To improve further the governance and management of pension funds, Government and the industry are also considering the professionalisation of the Principal Officer's role. This will possibly entail having the Principal Officer play an executive role on the Board, with responsibility for the day-to-day running of the pension fund. Accountability, however, will always remain with the board of trustees.

7. Conclusion

South Africa has a large and well-developed pension fund industry, which has grown in response to individuals' needs to save, to manage individual irrationality, and to provide a stable source of capital for domestic investment. However, the South African Government has become increasingly concerned about the low savings rate of South African households and their consequent lack of preparedness for retirement. To address these, effective policy must focus both on the preservation of accumulated pension savings to meet retirement needs, and the rate at which individuals access their funds at retirement.

This discussion document accordingly discusses the need to have a preservation and portability system to enhance the probability that pensioners are well provided for at retirement. Preservation arrangements will make a substantial contribution to the effectiveness of retirement incomes and enhance national savings. The proposed changes also seek to bring about equity of treatment across the various retirement savings products. A number of options on how preservation can be phased in are put forward. These are open to discussion and engagement with the public and key stakeholders, including NEDLAC.

Last, it is proposed that trustees adhere to governance principles and continually undergo training to increase their knowledge and to equip them to carry out their duties more effectively.

8. Request for comments

The public is invited to comment on the proposals contained in this discussion document by no later than **16 November 2012**. Comments may be submitted to:

Attention: Mr Olano Makhubela, Chief Director: Financial Investments and Savings, Private Bag X115, Pretoria, 0001. Or by fax to 012 315 5206; or by email to retirement.reform@treasury.gov.za

The paper released by National Treasury on 14 May 2012 titled *Strengthening retirement savings: An overview of proposals announced in the 2012 Budget*, (http://www.treasury.gov.za/comm_media/press/2012/2012051401.pdf) listed the following technical discussion papers for release during the course of 2012:

A. *Retirement fund costs* – Reviews the costs of retirement funds and measures proposed to reduce them.

B. *Providing a retirement income* – Reviews retirement income markets and measures to ensure that cost-effective, standardised and easily accessible products are available to the public.

C. *Preservation, portability and uniform access to retirement savings* – Gives consideration to phasing in preservation on job changes and divorce settlement orders, and harmonising annuitisation requirements. The aim is to strengthen retirement provisioning, long-term savings and fund governance.

D. *Savings and fiscal incentives* – Discusses how short- to medium-term savings can be enhanced, and dependency on excessive credit reduced, through tax-preferred individual savings and investment accounts. It also discusses the design of incentives to encourage savings in lower-income households.

E. *Uniform retirement contribution model* – Proposes harmonising tax treatment for contributions to retirement funds to simplify the tax regime around retirement fund contributions.

Papers B and C have been released and are available on the National Treasury website (www.treasury.gov.za). Note that paper C above referring to this paper has been renamed: *Preservation, portability and governance for retirement funds* – with paper B now titled *Enabling a better income in retirement*. Papers D and E, also have different titles from what was specified in the overview paper, and will be published before the end of September.

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