2012 BUDGET RETIREMENT SAVINGS DRAFT PROPOSALS

PRESS CONFERENCE | National Treasury

14 May 2012

national treasury
Department:
National Treasury
REPUBLIC OF SOUTH AFRICA

NB!

- THESE ARE DRAFT PROPOSALS FOR IMPROVING RETIREMENT SAVINGS
- THEY ARISE FROM THE BUDGET 2012 ANNOUNCEMENTS
- PRELIMINARY CONSULTATIONS HAVE TAKEN PLACE WITH VARIOUS STAKEHOLDERS
- FURTHER EXTENSIVE CONSULTATIONS WILL TAKE PLACE OVER NEXT FEW MONTHS
- BROADER PROPOSALS ON SOCIAL SECURITY REFORMS WILL BE RELEASED FOR PUBLIC DISCUSSION ONCE CABINET PROCESSES HAVE BEEN COMPLETED

Introduction

- Retirement funds play a crucial role in the economy, both at individual and at national level
- Government aims to increase the financial security of all households, and remains committed to comprehensive Social Security and Retirement Reform
  - An important element of this strategy is a mandatory national social security fund that provides pension, life insurance and disability benefits, in which area a paper is to be released in due course
- Government in process of improving quality of regulation, with a great focus on market conduct regulation as we shift to a Twin Peaks Model of regulation
- These <u>draft proposals</u> give effect to more urgent reforms (short to medium term) to the private retirement industry, which were identified in the 2012 Budget Review, and are complementary reforms:
  - Inadequate lifetime savings
  - Low levels of preservation and portability
  - High fees and charges
  - Low levels of annuitisation

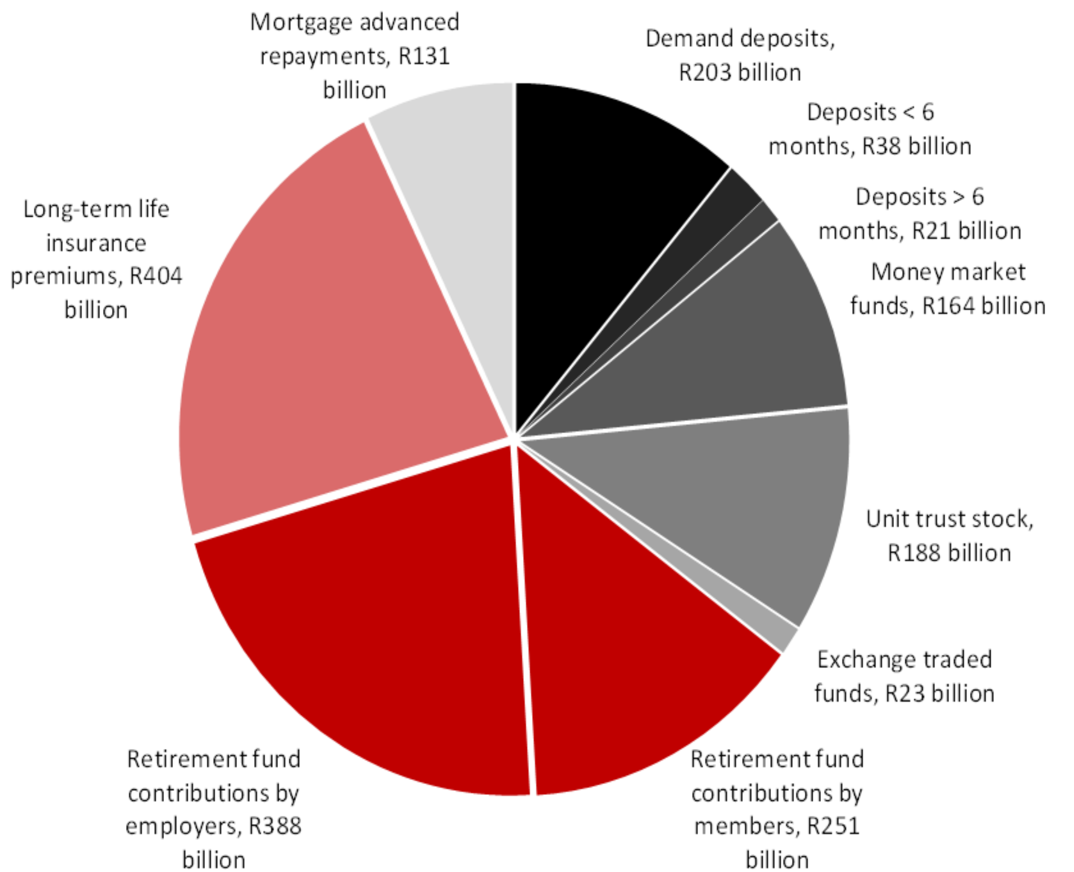
Savings and reform of the retirement landscape

- Proposed short- to medium-term reforms include:
  - Requiring preservation and portability
  - Improving fund governance and the role of trustees
  - Extending existing pension laws to all public pension funds
  - Reforming the annuities market
  - Creating a uniform approach to the taxation of retirement funds
  - Measures to reduce the costs of retirement products
  - Introducing tax incentives to promote retirement and other investment products
- A series of technical discussion papers will be released over 2012 in the above areas
- Longer-term reforms will be dealt with through Social Security Reforms

The context of retirement savings

- South Africa’s current gross national saving rate of 16% does not compare well with some of our BRICS counterparts like Chine (53%) and India (34%)
- National savings usually divided into government, corporate and household savings
- Net household savings have been negative since 2005
- Main household savings vehicles are retirement funds, long-term insurance, unit trusts and bank deposits
- Retirement savings include employer and individual contributions to retirement funds (incl. retirement annuities and preservation funds)
- Non-retirement savings include bank account, collective investment schemes, long-term insurance investment products and advance mortgage saving
- Currently, retirement funds (which manage around R2.4trn) are the destination of more than half of household savings, although flows out of retirement funds may have exceeded flows into them in recent years

Household savings flows, 1999 to 2010



Source: Association for Savings and Investment South Africa, South African Reserve Bank, JSE

Reasons for low household savings

- No single or easy reasons, but basic reason is that there are too many people who do not have jobs or earn sufficiently to save
- Also, most people focus on short term consumption, and forget about their future needs, even when they can afford to do so
- Structural reasons include increased access to credit
- Quality of financial education is low, and people often make the wrong choices between financial products (e.g. on type of annuity chosen)
- Poor governance and investment decisions over pension funds
- Costs of retirement products are too high and opaque
- Lack of a market conduct regulator to deal with market failures related to
  - Product differentiation to avoid competing on price
  - Reliance on a hybrid market, with a combination of pure procurement and competition

Preservation and portability

- One of the toughest challenges with our retirement system is the poor level of preservation when individuals change jobs
  - According to a 2011 Sanlam Survey, 70% of pension fund members who resigned or were retrenched, took cash withdrawals from their pension funds
- **Preservation** is critical and urgent to maximise savings and retirement income
  - Will be introduced following an extensive consultation process, and protection for vested rights
  - Even when introduced, some access to accumulated benefits may be allowed for the long-term unemployed, and for those with demonstrated medical need
- **Portability** will encourage the ability to keep accumulated pension benefits with former employer or to transfer to new employer in order to facilitate preservation at low cost
- **Extending pension laws to public sector pension funds** will ensure a level regulatory playing field
- Paper due to be released by June 2012

Improving fund governance

- Pension fund governance problems (e.g. conflict of interest, poor investment decisions) emerge from weaknesses in governing boards
  - No relevant experience and skills
  - Conflicts of interest
  - But this is a tough job!
- Overall Twin Peak proposals to introduce a Market Conduct Regulator and supervision should lead to improvements in governance and measures to protect member interests
- Specific proposals include:
  - Application of "fit and proper" standards
  - Put in place mechanisms to achieve proper training (e.g. trustee toolkit training a requirement)
  - Strengthen governance by elevating PF Circular 130 status
  - Empower trustees to act independently without fear or favour
  - Professionalise the role of principal officer

Reforming annuities markets

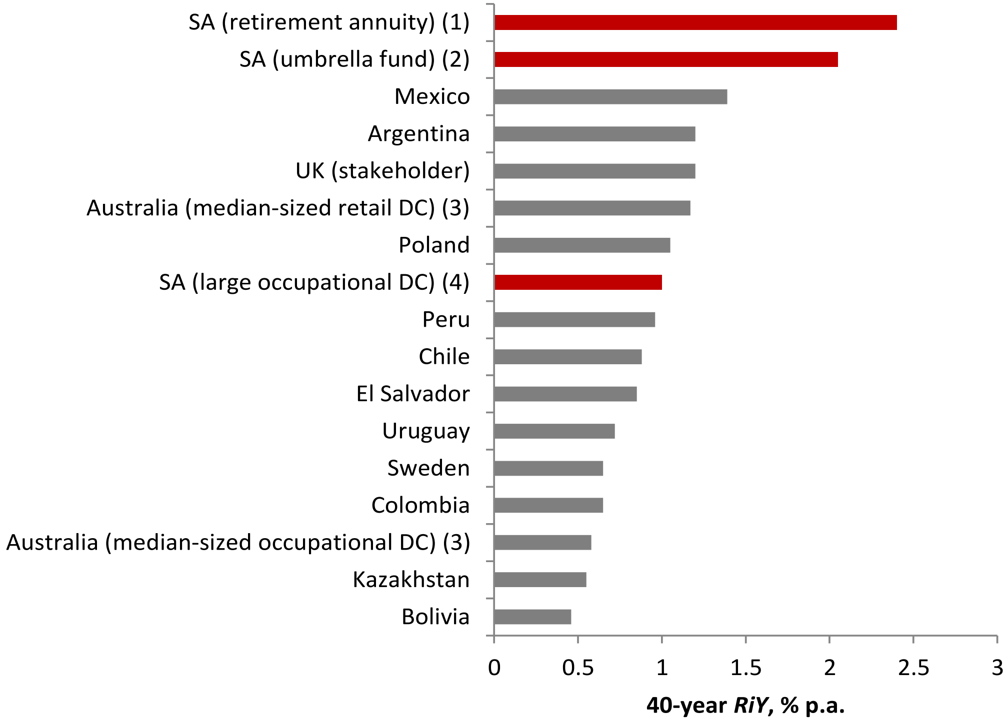
- An **annuities market review** has been conducted, with the objective of facilitating competition, reducing costs and improving transparency
  - Too few South Africans (~ 10% by value) appear to be purchasing conventional life annuities
  - Living annuities are expensive (costs may reduce income by up to 1/5th) and may be exposing too many South African retirees to investment risks and the risk of outliving their assets
  - Low-income South Africans, in particular, may be getting poor value for money in the annuities market
- Consideration to be given to:
  - Developing standardised products into which retirement funds can automatically enroll members
    - These products will have to meet conditions on design, access and cost
  - Expanding the eligibility of living annuity provision to other intermediaries (e.g. Collective Investment Schemes & Government Retail Bond Scheme)
  - Encouraging the more accurate pricing of conventional life annuities
- Review is currently under discussion with industry, with the aim of developing concrete proposals
- Final review due to be released by June 2012

Harmonising retirement fund taxation

- Uniform retirement contribution model:
  - In consultation with important stakeholders, proposes harmonising the tax treatment of contributions to and benefits from pension and provident funds (and retirement annuity funds)
  - Will substantially reduce the complexity of our current retirement system
  - Achieve greater equity in the tax system by rationing tax exemptions
- Treatment of contributions:
  - Employer contributions treated as a fringe benefit for tax purposes
  - Exemption for employer & employee contributions, up to a percentage ceiling (22.5% of income, 27.5% for 45 and above), and up to a rand amount (R250 000 and R300 000, latter for 45 and above)
- Treatment of benefits:
  - Proposal to phase in annuitisation of 2/3rds of provident fund benefits, similar to pension and retirement annuity fund
  - Proposal to be phased in with protection of vested rights
  - Consideration being given to raising *de minimus* annuitisation requirement from R75 000 to limit effect of proposal on low-income households
- Some of the proposed legislative amendments will be published with the relevant discussion document
- Paper due to be released with the tax proposals by August 2012

Measures to reduce retirement fund costs

- A **costs review** has been conducted, with the objective of reducing the cost structure of the existing industry.
  - High and layered charges, especially annual charges, significantly erode retirement benefits (e.g. charges in one preservation fund on the market may reduce retirement fund benefits by up to 40% over 30 years)
  - South African retirement funds of all kinds appear expensive relative to international benchmarks



Source: Whitehouse (2000) unless otherwise indicated. Figures refer to mandatory national retirement systems, unless otherwise indicated.

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Measures to reduce retirement fund costs

- Proposals of the review include:
  - Measures to increase competition on the basis of price rather than product design and investment performance
  - Encouraging the use of low-cost passive investment management
  - Preventing the cross-subsidisation of different services to give consumers sufficient price information to make informed choices
  - Exploring exempting certain standardised retirement products from FAIS requirements
  - Reforming distribution channels to reduce conflicts of interest between intermediaries and customers
- Review currently under discussion with industry with a view to developing concrete proposals
- Final review due to be released by October 2012

Non-retirement tax-free savings proposals

- In recognition of the fact that retirement savings are currently used for short and medium-term savings goals, some consideration is being given to alternative products to raise the after-tax rate of return on these savings
- **New tax-free savings instrument:** Tax free capital growth and income product with contribution caps to encourage individuals to save for short- and medium-term needs without relying on retirement funds or excessive credit
  - R30 000 contribution cap per year
  - R500 000 lifetime contribution cap
- **Mechanisms similar to Fundisa program are under consideration**
  - Co-contributions (rather than tax exemptions) to encourage those falling outside the tax net to save for short and medium-term needs

- Paper due to be released by August 2012

Process going forward

- Comment on overview document by 31 July 2012
  - The Chief Director of Financial Investments and Savings, Olano Makhubela, Private Bag X115, Pretoria, 0001; or per facsimile to (012) 315 5206; or per e-mail to retirement.reform@treasury.gov.za.

- Further comments on technical discussion papers at later submission dates in 2012
- Further consultation with trade unions, employers, retirement funds and broader public will refine draft proposals
  - Workshops to be arranged