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Encouraging South African households to save more for retirement

Introduction

Government has been progressively reforming and restructuring the savings and retirement legislative framework since the publication of a set of discussion papers following the announcement made in the 2012 Budget[1]. All these papers are available on the National Treasury website[2].

This paper deals with the key outstanding proposals from the retirement reforms initiated in 2012, regarding the promotion of higher level of savings, expanding coverage and promoting better preservation and more consolidation to reduce the costs and charges on members. This discussion paper makes proposals on the design structure of a ***two-pot*** system for retirement savings, which would restructure retirement savings to allow for limited pre-retirement withdrawal and introduce Government's longstanding retirement reform proposal on preservation.

Government will also introduce legislation to enable automatic/mandatory enrolment to expand coverage for more vulnerable, contract and temporary workers (e.g. domestics workers, uber drivers). Whilst workers that are formally employed and belonging to a labour union tend to be covered under the current dispensation, this is not the case with workers not belonging to any labour union, nor those in the gig economy. Further, consolidation of the retirement fund sector into a smaller number of large retirement funds could bring a few cost advantages to funds and members – including economies of scale, improved governance and disclosure. Annexure A to this paper provides further details.

A limited level of immediate access will be made available under specific conditions for those negatively impacted by the COVID-19 pandemic and similar emergencies. The proposed restructuring of retirement savings aims to address the situation where many members of funds find themselves cash strapped (because of not having any alternative or sufficient forms of short-term savings) and then they resign from their jobs to access their retirement savings. Such withdrawals should not undermine the long-term objective of building savings for retirement;

[1] http://www.treasury.gov.za/comm_media/press/2012/2012051402.pdf
http://www.treasury.gov.za/publications/RetirementReform/20120314%20-%20Strengthening%20retirement%20savings.pdf
http://www.treasury.gov.za/publications/RetirementReform/
[2] http://www.treasury.gov.za/publications/RetirementReform/

hence the design of the *two-pot* system which includes a preservation requirement to improve retirement outcomes and maintain the integrity and sustainability of retirement funds.

Public comments are requested on this paper by 31 January 2022. It is the intention that draft legislation will be published in line with the 2022 Budget process to give effect to the proposals in this paper, considering the comments received.

Helping households to save more to reduce vulnerability

South African households do not save sufficiently for retirement nor their short-to-medium-term needs. Household savings average just above 2 percent of GDP per annum, most of which is contractual savings for retirement funds. However, aside from the low level of savings for retirement, members tend not to preserve their savings, and commonly access them when leaving their jobs. As a result, replacement values at retirement are low. According to the Sanlam Benchmark Survey 2021 Report[3] (p 47) 'in South Africa, the average replacement ratio is around 25 percent to 30 percent, resulting in retirees simply concluding that they cannot survive on the starting pension offered by a guaranteed annuity'. Discretionary savings are also low, for example, one in three (34 percent) respondents to the annual Old Mutual Savings and Investment 2021 survey stated that they do not have enough savings to last more than a month (at most) if they lost their income/jobs. Furthermore, the survey indicated that 56 percent of respondents had 'high and overwhelming financial' stress levels in 2021.

This means that most South Africans are vulnerable while they are working and, in their retirement, when many can no longer work, find employment or their health is failing them. Knowledge of investment, discretionary savings, and retirement savings is generally poor in South Africa, and individuals do not save for 'rainy days' or retirement. They do not sufficiently insure their lives for the benefit of their dependents nor insure properties in case of a loss. Financial education is key for all South Africans to help reduce financial stress and increase income in retirement. The earlier working households start to save and be financially informed, the better the financial outcome throughout their life cycles.

The COVID-19 pandemic has demonstrated the fragility of households, and the need to proceed with more speed with government's initiatives to increase household savings and make households less vulnerable. Many economies across the globe are currently facing economic decline because of the pandemic, which has forced several jurisdictions to come up with extraordinary proposals to avoid economic collapse and allow access to retirement assets to help the economy and households.

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[3] www.sanlam.co.za/corporate/retirement/benchmarksurvey/Documents/Research-Insights-Report-2021.pdf

In South Africa, many small businesses are shutting down during this period of the COVID-19 pandemic. According to Statistics South Africa (STATS SA), a net decrease of 1,4 million in total employment in Q1: 2021[4].

South Africa has a well-developed retirement fund system that many of its workers depend on, thus enabling them to build up assets to retire comfortably. The reforms implemented over the past decade aim to reduce vulnerability in retirement, with the completion of recent reforms to post-retirement preservation implemented from 1 March 2021. The next phase of amendments now aims to ensure a more conducive policy environment to encourage pre-retirement preservation, while still supporting the financial needs of members.

Policy options to amend the retirement system to improve pre-retirement preservation were detailed in the paper *Preservation, portability and governance of retirement[5] funds* that was released on 21 September 2012 and in the paper *2013 Retirement reform proposals for further consultation* released on 27 February 2013[6]. The provisions that govern pre-retirement withdrawals aim to balance three objectives:

- Encourage savings through regular contributions to a retirement fund during a person's economically active years;
- Preserve retirement funds as far as possible to fund benefits in retirement; and
- Allowing partial access to retirement funds to cater for periods of financial distress and improve flexibility.

Government recognises that precautionary savings have merit beyond its contribution to retirement benefits. In a high-risk environment, some level of pre-retirement access to retirement savings enables households to reduce unexpected financial hardships and may lead to a greater willingness to save through retirement funds. While ongoing analysis has pointed out the disparities in pre-retirement access provisions for different retirement products, the extraordinary shocks that members and their households have experienced recently have illustrated the need for a balance that retains an appropriate measure of flexibility while improving preservation over the longer term.

Outstanding reforms to the retirement system relate to the following three key remaining problems:

- **Coverage:** Whilst the current retirement system covers many workers, there remain significant categories of workers who are not participating in any retirement scheme;

[4] Statssa, Quarterly Labour Force Survey Quarter 1: 2021, p. 4

[5] http://www.treasury.gov.za/comm_media/press/2012/Preservation%20portability%20and%20governance%20%2021%20Sept%202012%20.pdf

[6] http://www.treasury.gov.za/publications/RetirementReform/

- **<u>Preservation</u>:** Many members of retirement funds do not preserve their savings, tending to cash out every time they change jobs. Whilst the default regulations do assist with preservation, significant loopholes remain; and
- **<u>Costs</u>:** Whilst the costs applying to retirement funds might be made more transparent, most of the cost structure of retirement funds relates to the size and number of funds, which are not economical.

Government has announced its intention to respond to these three challenges, by introducing an auto-enrolment or mandatory system of retirement saving for all employed and self-employed persons, to widen and deepen coverage. Secondly, there is a need to consolidate the many funds into a few bigger funds, to reduce costs for all members. Thirdly, government would like to introduce a *two-pot* system, to allow for limited withdrawals by members and to remove loopholes that have undermined preservation.

Retirement fund members and contributions

According to SARS' IRP5 certificate data, in 2017/18 there were around 6.8 million individuals who contributed to a pension fund, provident fund, or retirement annuity fund, with around 2.9 million making contributions to a pension fund, 2.7 million to a provident fund, and 1.7 million contributing to a retirement annuity fund. It must be noted that many individuals have membership to multiple funds, therefore due to duplication, the total, by fund type, does not add up to the total number of individuals in the second column.

Table 1: Fund membership numbers[7]

Tax year	Total	Pension: employee	Pension: employer	Provident: employee	Provident: employer	Retirement annuity
2011	4,882,693	2,858,053	0	1,405,231	0	1,485,455
2012	4,974,950	2,907,731	0	1,424,492	0	1,548,314
2013	5,181,628	2,947,824	0	1,564,589	0	1,619,897
2014	5,344,076	2,974,068	0	1,704,501	0	1,648,594
2015	5,480,548	3,001,332	0	1,836,035	0	1,635,156
2016	5,562,945	3,024,830	0	1,930,519	0	1,577,381
2017	6,884,845	2,941,065	2,850,786	2,777,879	3,321,877	2,278,073
2018	6,751,578	2,935,220	2,834,200	2,771,154	3,354,107	1,746,229

Source: SARS anonymised tax data

In terms of contributions, a total of R246 billion was contributed into these accounts in 2017/18. The largest contributions were made by employers to pension funds, at close to R100 billion, with R53 billion in contributions by employees. Provident fund employer contributions were around R44 billion with employee contributions at R19 billion. Retirement annuity fund contributions were around R32 billion.

[7] From 2016/17 onwards provident fund employee contributions became deductible and a higher percentage contribution for all retirement funds was allowed, alongside a monetary cap of R350 000.

Table 2: Fund contributions

Tax year	Total	Pension: employee	Pension: employer	Provident: employee	Provident: employer	Retirement annuity
2011	49,786	31,243	0	4,982	0	13,560
2012	52,731	34,135	0	3,523	0	15,074
2013	58,491	37,157	0	4,255	0	17,079
2014	64,063	40,158	0	5,343	0	18,562
2015	69,449	43,194	0	6,199	0	20,056
2016	74,085	45,957	0	7,526	0	20,602
2017	240,822	49,853	91,647	17,413	41,704	40,206
2018	246,051	53,509	98,184	18,816	43,780	31,762

Source: SARS anonymised tax data

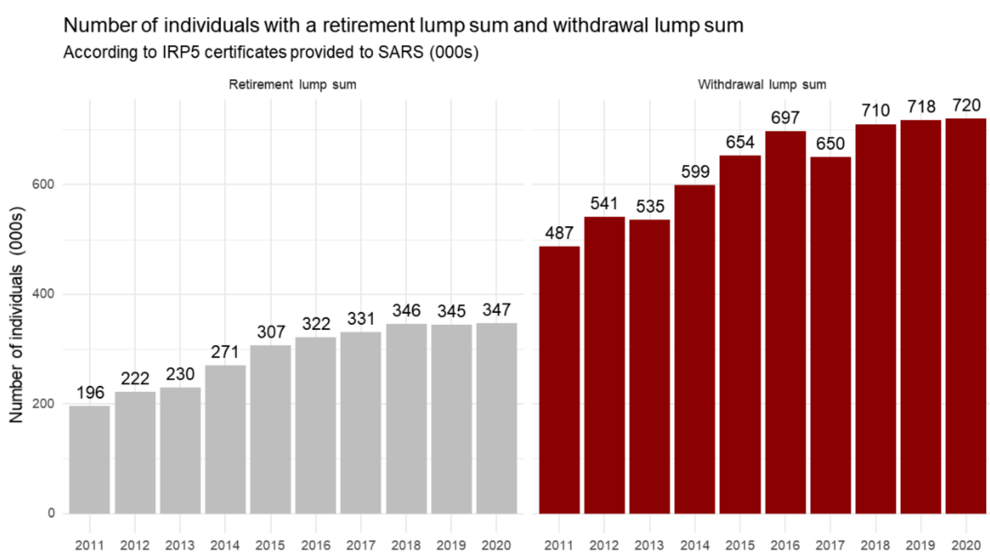
What is the problem?

There are two main concerns with the current policy design of retirement funds:

1. There is insufficient preservation of retirement funds before retirement; and
2. Individuals in financial distress can access all their retirement funds upon resignation, and hence are left with very low, if any, savings when they retire.

1. There is insufficient preservation of retirement funds before retirement

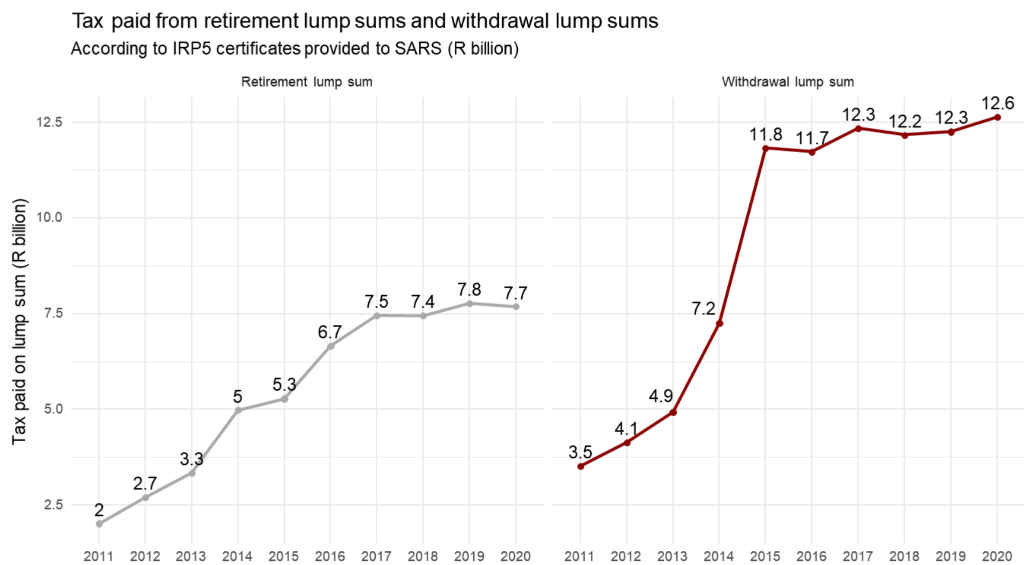
- Individuals with a pension fund or provident fund can withdraw the full value of their pension or provident fund when they resign or are retrenched from employment.
- Even if an individual transfers their pension or provident fund upon resignation to a pension preservation fund or provident preservation fund, they are still allowed a 100 percent once-off withdrawal at any time before retirement.



These two design features in the current system create leakages out of the retirement system, which leads to low replacement rates and poor outcomes in retirement. Statistics from the retirement industry and tax data confirm that many individuals cash out at least a portion of their pension or provident fund, particularly upon resignation or retrenchment.

Government imposes a substantial tax on withdrawals made before retirement as a disincentive to depleting assets before retirement, however, given a large number of withdrawals, the high tax rate does not appear to be a sufficient consideration in minimising this behaviour.

Data from SARS, for each of the last 3 years, indicates that over 700,000 individuals cashed out a "withdrawal lump sum" before retirement. Around half that number received a "retirement lump sum" (through retirement or retrenchment). The tax paid on withdrawal lump sums (which faces a relatively punitive tax rate) is over R12 billion each year on an average withdrawal lump sum amount of around R110 000, while the tax paid on the more generous retirement tax tables is



over R7 billion on an average retirement lump sum of around R220 000.

According to this data, around R78 billion is taken out of the retirement system through withdrawals made before retirement each year (contributions to retirement funds in the IRP5 data total R246 billion each year). This large leakage reduces funds available for employees in retirement, contributing to low replacement rates.

2. ***Individuals in financial distress can currently only access their retirement funds by resigning***

    - Allowing access to the full value of the pension or provident fund upon resignation creates an incentive for employees in financial distress to resign, which increases the risk of future financial problems if they cannot regain employment.

- There is no ability for those in financial distress to access any amounts if they have assets within a retirement annuity fund or in a pension preservation fund or provident preservation fund if they have already utilised the once-off withdrawal.

While these problems have been present for a long time, the repercussions of the pandemic and the extended lockdowns have exacerbated the calls for additional short-term access to retirement funds that are not available to households who are under financial pressure.

These two problems appear to be in opposition to one another – on the one hand, there is a need for greater preservation while on the other hand there is a need to allow individuals to get some access without placing their employment at risk. Any reform should strive to find the right balance to solve both problems, one that promotes preservation but allows for some flexibility that works in members' long-term interests.

What is the policy proposal?

Government is sympathetic towards the difficulty many South Africans are currently facing and has continuously been engaging with the regulators and other key stakeholders to work out relief measures for consumers. As a result, measures on contribution suspension and holiday, as well as expansion of access to living annuities were enabled to ease the plight of some members.

Even though retirement savings should be used for their intended reason, namely retirement provision, Government recognises that there might be a need to allow some access to accumulated retirement savings before retirement. It is for this reason that the National Treasury noted, in the Budget 2021 financial sector updates, the consideration to allow limited pre-retirement withdrawals from retirement funds under certain conditions, if this is accompanied by mandatory preservation at resignation.

Further, requests for early access to retirement savings have been made both before and after the advent of the current COVID-19 pandemic. As a result of the increased possibility of such ongoing requests, Government is considering restructuring its retirement policy provisions to allow limited pre-retirement withdrawals in a manner that safeguards future benefits beyond the pressing financial needs that arise because of the COVID-19 pandemic or due to possible future periods of financial distress for retirement fund members.

One of the options currently being considered is a *two-pot* system, which will enable the restructuring of retirement contributions into *two-pots*.

The one account can be accessed at any time and the other account will not be accessible before retirement and must therefore be preserved until retirement.

It is proposed that one-third of any future contributions should go into the accessible retirement fund account and the other two-thirds goes into an account that must be preserved until retirement.

- Treatment of the extent of vested rights on amounts accumulated by implementation date is still under consideration, comments and options would be welcome on how vested rights can be protected.

Allowing access to one-third of future contributions at any time and removing the ability to withdraw the full amount upon resignation, will eliminate the incentive to leave employment to gain access to retirement funds. Greater accessibility and flexibility could also encourage more savings into retirement funds. The accessible portion would be available at any time (but can only be withdrawn at most once a year, depending on a fund's ability to effect withdrawals and subject to a minimum value, say R2,000), which would assist households if they needed funds for emergencies, without contemplating resigning to obtain those resources. The *two-pot* system spreads the availability of the lump sum that would usually become available upon retirement over the lifespan of the member, so that it is accessible when it is most needed.

The withdrawing member would have to incur the cost of a withdrawal so that non-withdrawing members do not subsidise the cost of those withdrawing. A withdrawing member would have to update his member details with the fund and whatever details would be necessary to effect a withdrawal. A member may also be required to undergo retirement benefit counselling or financial awareness before a withdrawal is undertaken. A withdrawal from a retirement fund reduces the savings for retirement for a member, and they should be encouraged to increase their future retirement savings to replace what is being withdrawn (e.g. by increasing monthly contributions after a year).

By combining a greater level of access with the restriction that two-thirds of contributions go into a pot that must be held until retirement, a much larger amount should be preserved in the retirement system compared to the current situation. This should increase the amount of assets available for the individual when they retire and increase replacement rates in retirement.

The vested rights provisions, though limited, will reduce the need for any employees to resign before the amendments become effective, as when they resign at any point in the future, they would still be able to withdraw an agreed amount of their retirement interest (together with growth on that amount) that was available at the implementation date. There would be no vested rights for individuals starting a new job after the implementation date[8].

Pension preservation funds and provident preservation funds do not receive contributions, but they will also be required to implement the *two-pot* system. Transfers into pension or provident preservation funds would mirror the structure of the transferor fund. This will enable members to continue to be allowed to withdraw from the one-third accessible pot from a preservation fund at any point after the implementation date. The once-off withdrawal for the two-thirds preserved pot in pension preservation funds and provident preservation funds would be removed for contributions made after the implementation date. However, the once-off withdrawal would still

[8] Although there will be vested rights for amounts transferred from a fund associated with a previous period of employment into a preservation fund or a fund linked with the new employer.

apply for any vested right amounts that are transferred into these funds from pension and provident funds (even after the implementation date). Vested rights should also apply for any amounts within the pension preservation and provident preservation funds where the once-off withdrawal has not been exercised (otherwise everyone may utilise the once-off withdrawal before the amendments are effective).

Below is a summary of how the proposed *two-pot* system may look:

	Vested pot occupational pension	**Vested pot occupational provident**	**Access pot**	**Retirement pot**
Contributions	All pension fund contributions before 1 March in the implementation year	All provident fund contributions before 1 March in the implementation year	1/3 net* contributions from 1 March in the implementation year (*net=net of risk premiums & admin charges)	2/3 net* contributions from 1 March in the implementation year (*net=net of risk premiums & admin charges)
Investment growth (positive or negative)	Investment growth added	Investment growth added	Investment growth added	Investment growth added
Access rule	Can access in full in future if change jobs	Can access in full in future if change jobs	Can access at any time (but at most once a year)	Must preserve until retirement
Retirement rule	Must annuitise 2/3rds, but subject to de-minimis	May take in cash at retirement – subject to 1 March 2021 provisions	May take (any) balance in cash at retirement	Must annuitize in full, but subject to de-minimis
Implementation year is anticipated to be 2023				

Withdrawals from the accessible account?

The retirement fund industry is founded on providing longer-term investments to create a lump sum that can be used for an annuity at retirement, therefore, it is not geared towards providing immediate access to funds or offering quasi-transactional accounts. Shorter-term savings vehicles, such as fixed deposits, ETFs or unit trusts, provide a better mechanism for individuals to obtain returns while retaining the option to access those funds if needed. Creating an accessible pot from one-third of future contributions upends this distinction between retirement savings vehicles and short-term savings vehicles.

It is unlikely that individuals need another transactional account, and from a policy perspective, it is not the intention to allow a member to withdraw one-third of their contributions each month.

Under the current tax system, this would also require a tax directive each month from SARS to check the cumulative withdrawal per taxpayer to calculate the tax to be paid according to the current tax dispensation. The previous discussion paper released at Budget 2013 proposed that individuals could withdraw the greater of 10 percent of their balance or the old age grant value each year. If no withdrawal is made, then the potential withdrawal amount is cumulative (e.g., after 5 years an individual could take out the higher of 5X10 percent of the fund value or the cumulative value of the old age grant).

A key component of the previous proposal was that it should not create a time limit for when someone can access those amounts, otherwise individuals will feel forced to access those funds as soon as the opportunity arises. This should be avoided with the *two-pot* approach as the full value would be accessible in future.

The proposal is that individuals would be able to make a withdrawal from the one-third access pot at any time, but they cannot make more than one withdrawal per year. Individuals should not feel forced to make a withdrawal, as the option to do so would still be available to them at any point going forward.

There may still be an incentive for individuals to withdraw the full allowable amount of their funds in the one-third access pot if they make a withdrawal under this design since they would be required to wait a year until their next chance at a withdrawal. If they are worried that they may need additional funds before the year has passed, they may want to withdraw the full value rather than the portion that is required for their immediate needs. To mitigate this and improve preservation in the one-third pot, it is proposed that a second withdrawal be allowed within the year for any remaining amount if the individual made a partial withdrawal. For example, if someone had R100 000 in their one-third pot and they withdrew R70 000 on 1 September, they would be allowed to make a second withdrawal of R30 000 at any point up to 1 September in the following year. This would reduce the desire to take the full value on the first withdrawal but would increase administrative complexity.

Application of the *two-pot* system

Retirement annuity (RA) funds

The *two-pot* system would remove the incentive to resign to gain limited access to retirement assets, as well as increase preservation, for employees who contribute to a pension fund or a provident fund. However, there is currently no incentive to resign for those who contribute to retirement annuity (RA) funds as there is no access to those funds before the age of 55. Self-employed business owners often contribute to RA funds, as their incomes may fluctuate, and they are not eligible for membership of other fund types. As a result, a loss of business income can currently not be supplemented through access to RA assets.

By allowing a *two-pot* system for RAs, would reduce the amount that would be preserved by the time individuals reach the age of 55, undermining the first objective to ensure greater preservation, without fixing the same resignation issue that is present for pension and provident funds.

However, if RAs are not included in the *two-pot* system and no access is permitted before the age of 55 then there will be no way to assist individuals in financial distress (who are most likely self-employed). There would then be no progress on the objective to allow for greater access and flexibility for RA fund members.

A further consideration is simplicity and the harmonisation of retirement funds, which would make it easier for the public to understand and increase the potential for future consolidation and reduced administrative costs. If RAs were included in the *two-pot* system, it would be theoretically possible (because of tax harmonisation and the introduction of compulsory annuitisation for provident fund members) for each person to combine all their retirement fund holdings generated beyond the implementation date into a single retirement fund. (Although each fund would need to cater for several "pots" and vested rights.) Including RAs in the *two-pot* system would mean that pension funds, provident funds and RAs would all be identical in terms of tax treatment, pre-retirement preservation and post-retirement preservation[9].

Given that there would be greater discretion related to the use of RA funds if a portion of contributions were accessible before the age of 55, this may lead to greater demand for RAs. But it is unlikely that preservation would be increased overall due to this higher demand as contributions to RAs would need to increase by more than 50 percent[10] (from around R40 billion to R60 billion each year).

To allow for a simpler and more harmonised retirement fund system going forward, it is proposed that RAs be included in the *two-pot* system. This will satisfy the second criteria of allowing for early access but will partially undermine the first objective of greater preservation. Older generation RAs may require more time to operationalise the *two-pot* system.

Defined benefit funds and public sector funds

For Defined Benefit (DB) funds the value of the benefit for each employee is based on a formula rather than actual contributions, in contrast to defined contribution (DC) funds which have separate accounts with specific assets allocated to each individual that have been purchased from their contributions. For DB funds to be included in the *two-pot* system they would need to calculate a value for the one-third contribution at the time the employee asks for access and then sell assets from their wider portfolio to meet that obligation.

Since DB funds can project future liabilities based on expected annuity payments in future, they usually have a greater proportion invested in longer-term assets that are more illiquid. To cater

[9] The only difference would be the retirement age which is 55 for RAs, pension preservation funds and provident preservation funds and is fund dependent for pension funds and provident funds.
[10] If current contributions to an RA are R100 (which are fully preserved), would need contributions to go to R150 (up by 50%) for the 2/3rds preserved pot to get to R100.

for one-third of future contributions to be accessible at any point, this may require a shift in the composition of their portfolio to more liquid and shorter maturity instruments, which generally have a lower expected return. This may lead to a deterioration in the funding adequacy of DB funds if the *two-pot* system is implemented.

However, DB funds must already provide funds for employees at an unexpected time before retirement, as full access is granted when employees resign. DB funds calculate a value of the benefit at the time of resignation and either transfer that amount to the employee or a pension preservation fund[11]. This means DB funds, like the Government Employees Pension Fund (GEPF), may already be able to cater for a portion of liquid assets and paying members out before retirement.

Excluding DB funds will weaken the harmonisation objective as implemented over the past few years, and this will be weakened further if the tax treatment of contributions to funds in the *two-pot* system is adjusted.

There are potential benefits for all DB funds, including GEPF – contributions to the two-third preservation pot cannot be accessed at all until that individual retires. This will allow for a longer time horizon on these funds – particularly in the few cases where employees became entitled to full withdrawal upon resignation. The GEPF (and some state-owned entity pension funds) are not administered under the Pension Funds Act (PFA), and their inclusion under the PFA would enable simplicity, better harmonisation as well as transportability across funds.

It is proposed that all DB funds (including the GEPF)[12] are included in the two-pot system since they are already required to value benefits before retirement and already make large pre-retirement payouts to employees who resign or are retrenched. This proposal will be dependent on the inclusion of public sector funds under the ambit of supervision by the Financial Sector Conduct Authority through the Conduct of Financial Institutions legislation and the Pension Funds Act.

Example of the proposed two-pot system

Person A is employed and has R200 000 in a provident fund at the time of implementation of these amendments on 1 March 202X. From 1 March 202X onwards, one-third of their contributions are deposited into an accessible pot and two-thirds of their contributions are deposited into the retirement pot.

- *After two years, there is R20 000 in the one-third access pot and R40 000 in the two-thirds retirement pot and R220 000 in the vested right pot. Person A faces some financial difficulties and can withdraw the R20 000 from their access pot without*

[11] Since 1 March 2016, the actuaries for the fund also calculate the increase in the value of the benefit (unrelated to their contributions) as a fringe benefit for each employees' tax return.
[12] Would along with other public sector funds, be subject to the *two-pot* system once included under the regulatory and supervisory realm of the Pension Funds Act and CoFI legislation.

resigning to gain access to their retirement funds. No further withdrawals from the access pot can be made for one year (unless they made a partial withdrawal).

- *After another two years, Person A has R25 000 in the one-third access pot, R100 000 in the two-thirds retirement pot and R250 000 in the vested right pot. Person A resigns to join another company. On resignation, the one-third access pot and the two-thirds retirement pot would need to go to a preservation fund or the fund of their new employer. The one-third pot would still be accessible at any time. For the vested right pot, Person A would have the option to either:*
    - *Withdraw the R250 000 vested right, although the amount would be subject to tax according to the withdrawal tax table*
    - *Transfer the R250 000 to a provident preservation fund. The amount would remain eligible for a once-off withdrawal of up to the full value at any point before retirement.*
- *After another 10 years, Person A has reached retirement age. There is R75 000 in the one-third access pot and R600 000 in the two-thirds retirement pot. Person A retires and can withdraw the R75 000 from the one-third access pot as cash and is required to purchase an annuity with the R600 000 in the two-thirds retirement pot.*

Providing immediate partial access to retirement funds

Should there be immediate access to 10 percent (up to R25 000) of the retirement fund?

Some households have experienced hardships through the pandemic, although if an employee was retrenched, they would have been able to access up to 100 percent of their retirement assets (and in retrenchment the first R500 000 is tax-free if they have not had any previous withdrawals).

Employees who have not lost their jobs continue to receive income, however, someone else in the household may have lost an income which would create a rationale for income support. Those who are self-employed and had been contributing to an RA and who have lost their businesses or income will likely be those that are most in need of support. A similar position exists for those who experienced hardships but who had already utilised their once-off withdrawals from their preservation funds and have an amount remaining in those funds.

However, there are several risks with this proposal:

- Household balance sheets are in distress, but the same is also true of balance sheets elsewhere, due to unfavourable economic conditions. Therefore, the accumulated retirement interest is potentially at a low point, which means that current withdrawals have greater negative impacts on future benefits than they would have when markets recover.

- Each year SARS processes around 1 million tax directives to assess the tax that is required to be paid on retirement lump sum and withdrawal lump sum benefits. Opening this up to every person who contributes to a retirement fund could require the processing of up to 7 million tax directives, which may all come through to SARS as soon as the amendment is passed and put severe pressure on their systems and processes.

- It may lead to a run on retirement assets, which could create liquidity problems or even harm asset prices. With 7 million tax directives, the potential amount to be withdrawn from the retirement sector is R175 billion, out of R2 trillion in aggregate assets in privately administered funds.
- This may put significant administrative pressure on funds to be able to accommodate these requests, increasing overall costs.
- Individuals with multiple funds may request immediate access from each of their funds. SARS would need to ensure their directive process can reject multiple claims.
- If the fund suffers from excess withdrawals, this will create a penalty on members who have not withdrawn, especially for DB funds.

Most of these issues relate to the number of claims that could be made, so if immediate access is allowed, it should rather be restricted to those with the greatest need. SARS could potentially check IRP5 certificates to ascertain if there has been a percentage drop in income. But those who have lost income most probably lost their jobs, which means they would have been able to withdraw a portion, or all, of their retirement savings already. SARS may be able to analyse provisional tax payments for the self-employed to check for a drop-in income which might be a way to include the most vulnerable – those with RAs and preservation funds, who are distressed.

Another mechanism to reduce the scope of eligible claims is to limit this to RAs and preservation funds where the once-off withdrawal has already been utilised. These are the most vulnerable groups, as those who have lost their jobs would have been able to withdraw, while those who are employed continue to receive an income.

The eligibility criteria ignore a drop-in household income though, which would exclude individuals in dire circumstances. Picking a percentage drop in income will also be arbitrary and create further distress for those who only just do not qualify. The administrative requirements of determining who is eligible would also need to be checked with SARS but should not be underestimated.

There would also need to be a de-minimis on the lower end of fund values, as it may not be helpful to provide 10 percent of a small amount. The value at which a paid-up RA can be taken as a lump-sum before the age of 55 is currently R15 000. Industry can hopefully provide better statistics on the likely liquidity impact given different thresholds and percentages for immediate access for all retirement fund members.

If the initial access is available to everyone, it should not be a once-off opportunity as everyone would then opt to make a withdrawal. It could therefore rather be utilised as seed funding for the accessible one-third pot, which would be available immediately.

An alternative option considered for early access to retirement funds was guaranteed loans. The disadvantages of the proposed loan guarantee scheme are; a) loans are subjected to credit requirements of credit providers, b) most fund members are already in debt and might not qualify. This would preclude the relief from being accessed by pension fund members who need the assistance the most, resulting in an inequitable outcome for funds members. Significant numbers of pension fund members who are in the greatest financial distress might potentially not be able to access the envisaged relief.

Government agrees with the need to proceed with caution, given the macro-economic issues facing the country and also notes the need for care because the pension system is a key pillar of the SA economy, as noted in the recent report of the IMF Staff[13] concluding statement of the 2021 Article IV Mission: *"Reforms to the pension system need to be carefully designed to prevent undermining old-age security savings of the population and weakening one of the key pillars of the strong financial system."*

Considerations for tax treatment

South Africa follows a system that exempts contributions to retirement from tax, exempts growth through investment returns – but taxes retirement benefits when they are paid out, the so-called EET system (or EEt where the lowercase "t" indicates that the benefit is only partially taxed). This ensures that the income is only taxed at the time that it becomes disposable to the recipient – which is consistent with the Haig-Simons definition of income. From a tax technical perspective, this also ensures that it is not taxed twice. The equivalent could be achieved through a system that taxes contributions and growth from investment but exempts benefits (a TEE system), which is the design for tax-free savings accounts.

From a behavioural economic perspective, the EET design is a superior mechanism to overcome our intertemporal biases, as it is more compatible with findings of high present bias in most people's savings decisions. In short, we tend to value our current needs for consumption more highly than our future needs for income. This could lead to under-provision for our future-selves. A system that wields the tax "stick" on contributions and growth, before finally offering the "carrot" of exempt income in retirement provides no tangible current benefit to savers. The South African tax structure encourages retirement savings through tax deductibility when contributions are made.

As taxation is deferred to the benefit stage, there are tax provisions to ensure that early withdrawals attract tax – often at relatively higher rates than would be the case if the funds were preserved to retirement. From a fairness perspective, it is important that these funds attract tax once they become disposable in the hands of the member. The behavioural reasoning behind that design is to encourage preservation. As the data on withdrawals has shown, the punitive tax

13 http://www.treasury.gov.za/comm_media/press/2021/2021120801%20IMF%20Concluding%20Statement.pdf

rates on early withdrawals do not appear to have dissuaded individuals from accessing these funds before retirement.

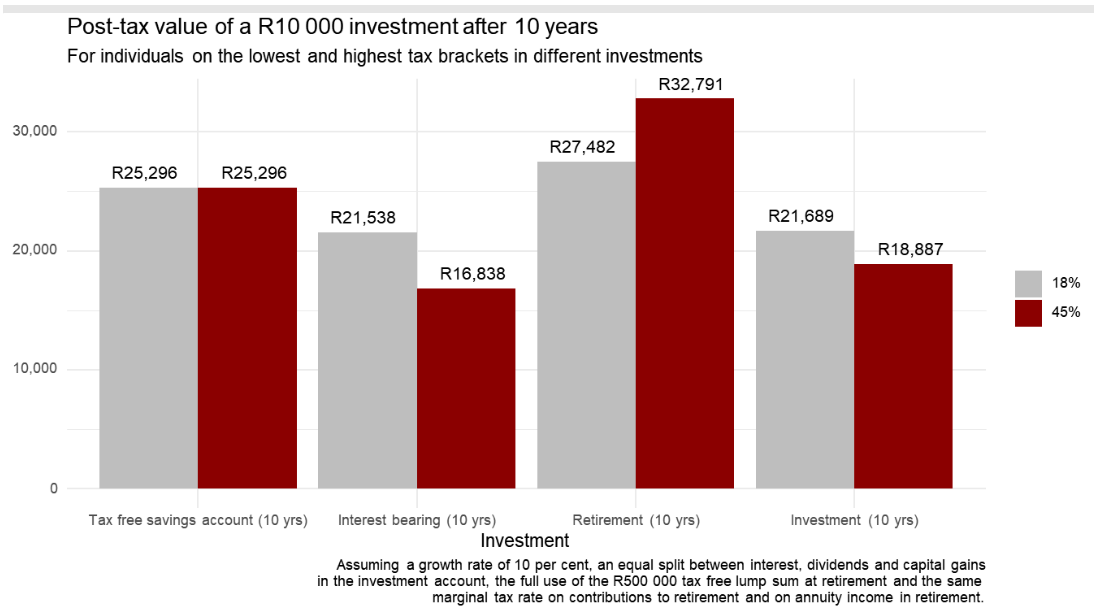
Principles that guide tax design for retirement

- *Strive for horizontal equity to enable harmonised tax treatment that is not determined by the form of the retirement vehicle*
- *Life-cycle treatment should result in income only being taxed once – preferably at the time that it is at the disposal of the taxpayer*
- *Where possible, incentivise savings – the longer the number of years the funds are saved, the greater the tax incentive (e.g. the lower the tax on withdrawal?)*

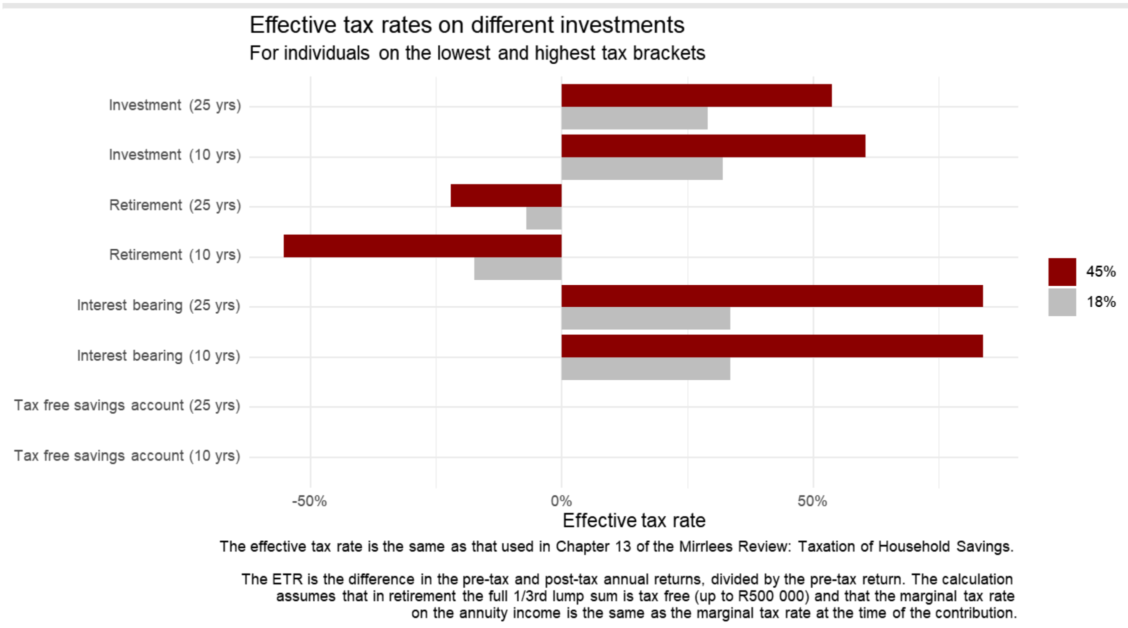
The remainder of this section considers tax design for each sequential element in the pension life cycle, to explore design considerations.

The current tax treatment for contributions held until retirement

Apart from life-cycle considerations and vertical equity considerations, we also have to compare the tax treatment of retirement fund investments with alternative investments to consider horizontal equity. Retirement funds receive the most generous tax treatment out of all investment products. The additional benefit compared to a tax-free savings account (TEE) is due to the lower tax rate on lump sums at retirement where the first R500 000 is, according to the retirement tax table, tax-free (EEt). After 10 years, a R10 000 investment is around R7 500 higher at retirement for someone at the highest tax rate compared to a tax-free savings account, and almost double the value of an interest-bearing account. This benefit will be enhanced if the average tax rate on the annuity income is lower than the marginal tax rate on the contributions.



A similar result is found when calculating effective tax rates (ETR) of different assets, as is done in the "Reforming the Taxation of Household Savings" chapter of the Mirrlees Review (2012)[14]. A longer time horizon leads to a lower ETR benefit for investments that are held until retirement.



The main tax question to consider is whether the current deductibility should apply to both pots, and there are also wider policy considerations about the equity and efficacy of the deductions.

Should the current treatment be retained, this would mean that contributions to both pots would remain deductible, subject to the proportion of income and monetary limits in legislation and that withdrawals would be taxed according to either the withdrawal tax table or the retirement tax table. The tax treatment of contributions and withdrawals need to be considered together as they both influence the overall return, bearing in mind that the upfront deduction is the main incentive to get individuals to contribute today for a benefit that may only occur many years in the future. Careful consideration needs to be given to the vertical equity implications of upfront deductions (which, to a greater degree, benefit those on higher incomes, especially if the tax on the benefits is lower than the deduction on the contributions) and the effectiveness of tax incentives in increasing retirement contributions.

[14] https://ifs.org.uk/uploads/mirrleesreview/design/ch14.pdf

The tax treatment for amounts withdrawn before retirement

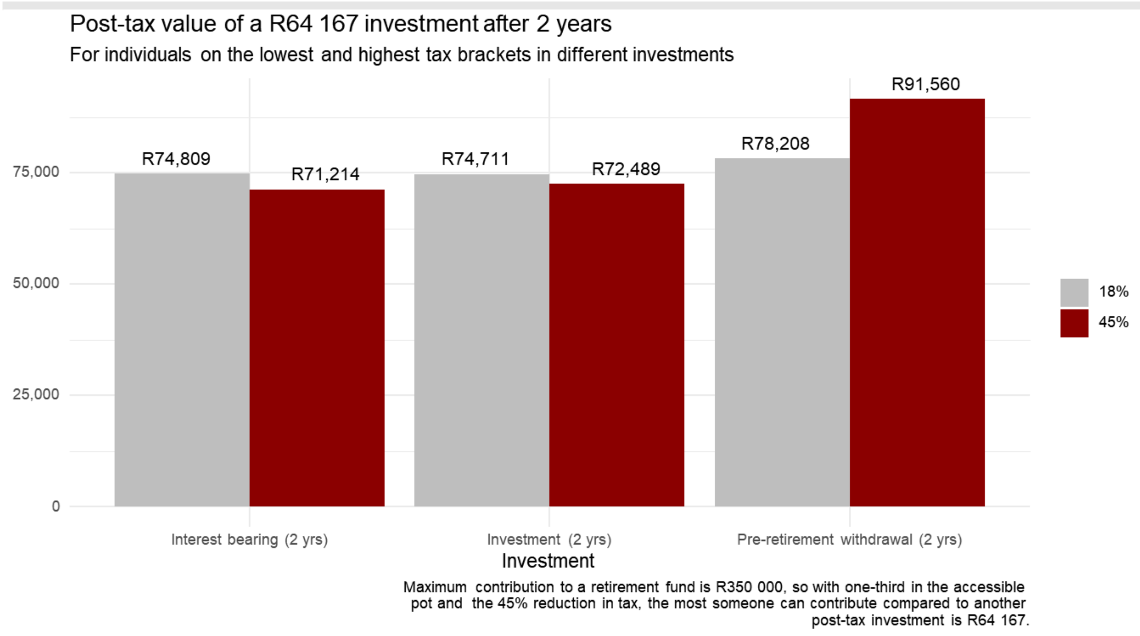
The withdrawal tax table is considerably more onerous than the retirement tax table, as the first tax rate of 18 percent starts at R25 000 rather than R500 000. Even so, the top tax rate of 36 percent for cumulative withdrawals above R990 000 is lower than the top marginal tax rate of 45 percent. This structure creates a potential tax arbitrage as the tax saved through the deduction on contributions is larger than the withdrawal lump sum tax on any withdrawals before retirement.

Tax arbitrage is not as likely to be easily harnessed under the current regime since pre-retirement withdrawals are linked to resignation or retrenchment. The decision to resign is not likely to be influenced by the tax arbitrage potential (and is not a factor at all for retrenchment).

The proposed regime will change the dynamics of tax arbitrage, as there will be a greater choice from the employee on when a withdrawal can take place. If RA members were included, where contributions need not be linked to employment at all, the tax considerations for potential arbitrage would be even more distinct.

Even if a one-year delay on withdrawals is in place, taxpayers would be able to take advantage of this tax differential. For example, once implemented, someone would be able to contribute up to R350 000 to a retirement fund the day before they can make a withdrawal. One-third of that amount would go into the accessible pot, and for someone on the top tax rate of 45 percent they would save/avoid R10 500 in tax by withdrawing that amount at the top withdrawal tax rate of 36 percent the next day, with larger savings for a lower tax rate on the withdrawal.

The tax-free growth within the retirement fund creates a further tax advantage if funds grow within the account before the withdrawal. For example, compared to a regular investment, the maximum contribution to the one-third accessible account that is withdrawn after two years would save around R19 000 in tax.



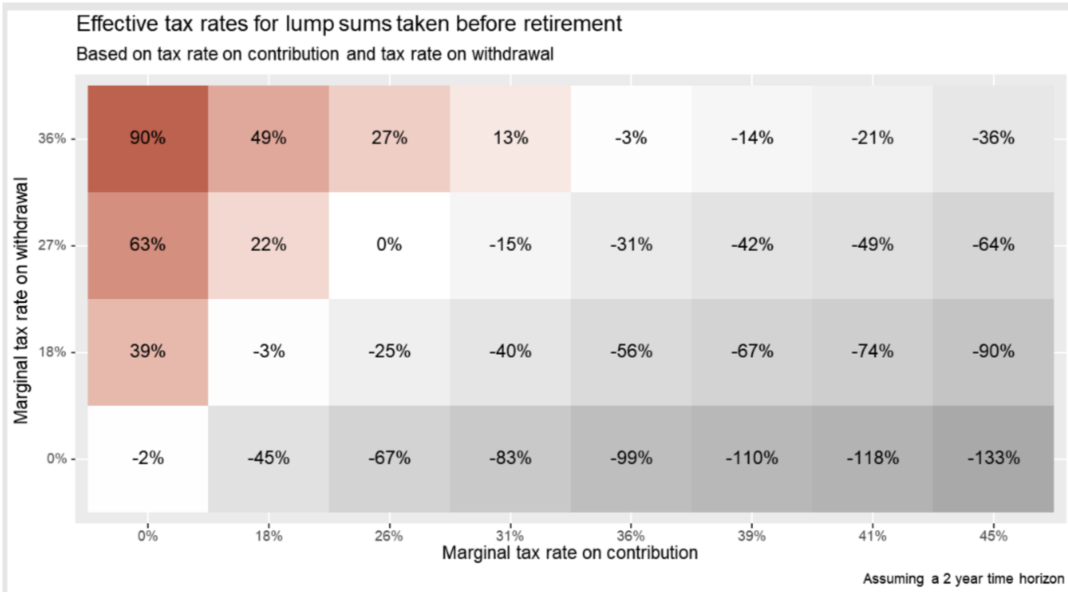
The rationale for the tax-advantaged treatment of retirement funds is based on providing an incentive for individuals to save for retirement since individuals are short-sighted and avoid saving for a benefit many years in the future. This rationale is weakened when individuals can access those funds in the short term.

Unintended tax treatment for edge cases

The ETRs on pre-retirement withdrawals are dependent on the tax deduction for the contribution and the tax paid on the withdrawal amount. As discussed above, even for amounts taxed at the top withdrawal tax rate, there is a large negative ETR for those at the top marginal income tax rate of 45 percent (top right of heat map below).

Unfortunately, the mismatch between the tax rate on contributions and the tax rate on withdrawals creates a less favourable tax treatment for those on lower incomes. An individual earning less than the tax-free threshold who contributes to a retirement fund, but has withdrawn more than R25 000 previously, would face a much higher effective tax rate on any future withdrawals (left side of heat map).

The current tax design creates inequities that are more likely to penalise those on lower incomes. This is exacerbated by the quirk in the current system where any pre-retirement withdrawals are included in the cumulative amount that is considered for the tax-free amount on retirement (i.e., if someone withdraws R150 000 before retirement and pays tax according to the more penal withdrawal tax table, they will only be eligible for a R350 000 tax-free lump sum on retirement). Effectively if anyone withdraws R500 000 or more before retirement, there will be no tax-free lump when they retire. Although this creates a double disincentive to withdraw before retirement, these barriers are not sufficiently salient to change behaviour.



Options for adjustments to the tax treatment of contributions and withdrawals

Due to concerns around tax arbitrage, the potentially high tax rates on lower-income earners and the fact that the one-third pot can be used as a short-term savings vehicle, the current tax treatment for contributions to, and withdrawals from, the one-third access account is unlikely to be appropriate. National Treasury will investigate potential alternatives (of which there are many international designs[15] to use as a comparison) for the tax treatment of the one-third access pot that will try to retain incentives for individuals to save while improving equity and limiting the risks to the fiscus. These could include:

1. Adding withdrawals from the one-third access pot to taxable income in the year of withdrawal
    - This would limit the potential for tax arbitrage since if an individual received a deduction on the contribution and shortly thereafter made a withdrawal, it would be added back to taxable income in that year. Individuals may still withdraw in a later year to generate a tax advantage if their marginal tax rate is lower, but this is likely to be less of a concern than the current design. As the account is intended to help those who are in financial distress, the tax liability would automatically be lower in cases when there is a sharp drop in income. This design also discourages

[15] http://www.oecd.org/finance/Stocktaking-Tax-Treatment-Pensions-OECD-EU.pdf

large lump-sum withdrawals since larger withdrawals will face a higher tax rate, although the amounts remain available if needed.
    - A concern with this approach is that the retirement fund would not be able to determine the amount of tax that should be withheld as it would be dependent on the level of taxable income at the end of the year (unlike the current system where a tax directive determines the exact amount of tax applicable on similar withdrawals). This could lead to either unexpected tax bills from SARS at the end of the year or the presence of a refund, which would only be transferred if the individual filed a return.
2. Switching the application of tax from withdrawals to contributions for the one-third access pot. The tax structure would move from an EET regime to a TEE regime for contributions to this pot.
    - In effect, this would create a tax-free savings account within a retirement fund. There would be no tax arbitrage issues and no cases where lower income individuals face a higher ETR compared to higher income individuals. Retirement funds need not apply for a tax directive for withdrawals as there would be no withholding tax on withdrawals.
    - Since tax is paid upfront there would be a smaller initial deduction and a potential reduction in net income. Although over the lifetime of the investment there would be no difference as the benefit is tax-free (EET gives the same final investment value as TEE).
3. Moving to a flat deduction percentage for contributions
    - For example, individuals could receive a 30 percent deduction on their contributions. The deduction is unrelated to income and would be more beneficial for those on lower income tax brackets, improving the progressivity of the tax regime. Lower-income individuals would see an increase in net income as their deduction increases, while the opposite occurs for higher-income taxpayers that face a marginal tax rate above the level of the flat deduction. Tax on withdrawals could either be at the same flat rate (which would not require the retirement fund to obtain a directive and would avoid refunds or unexpected tax liabilities) or could be added to taxable income for that year (with the same benefits and disadvantages as discussed previously).
4. Keep the current tax design
    - If the concerns with the current system are not sufficiently serious to warrant an adjustment.

One aspect that would require particular attention is the treatment of contributions in excess of deductibility limits. Currently, any contributions that are not deductible are added to the tax-free lump-sum on retirement or can be used to reduce the tax paid on the receipt of annuity income. The application of these limits needs to be carefully assessed under each option. For example, if the tax treatment of contributions to the one-third access pot mirrored that of the tax-free savings account, individuals may be able to contribute an amount much higher than the current deductibility limits into this accessible pot to take advantage of the preferential tax treatment. For this option, a limit on transfers into the one-third access may be required, which would match the design of the tax-free savings accounts which has an annual contribution limit.

QUESTIONS FOR PUBLIC CONSULTATION:

Government wants to facilitate higher levels of discretionary and retirement savings and simultaneously allow access to retirement funds to help some households to recover from the negative effects of lockdowns that have worsened economic decline and unemployment. These are difficulties from a policy point of view that require the balancing of many needs. In responding to this paper, these should be kept in mind and the following questions may be a guideline.

BALANCING ACCESSIBILITY AND PRESERVATION

a) What is the optimal way to build up the savings pot while ensuring that fund members have enough for retirement?
b) Given that retirement savings are often not enough to last well into retirement, further exacerbated by the effects of Covid-19; should there be immediate access to retirement benefits or consideration of a buildup of the accessible savings pot over time before allowing access? Under which conditions should either of these two instances be permissible?
c) What proportional increase in liquid assets held do funds anticipate due to the accessible pot?
d) Are there any suggestions for the tax provisions that can support the intended reforms, to ensure that tax is fair, equitable, efficient, simple and certain?

COVERAGE AND ENROLMENT

e) To what extent do the proposals on enrolment require changes to labour or financial legislation?
f) How best can mandatory enrolment be implemented?
g) Would auto-enrolment be a prior and transitional step towards mandatory enrolment? By how much should mandatory enrolment be phased in? (Example, up to 10 percent or 15 percent of gross remuneration?)
h) How best should a default fund be established for the benefit of those in the informal sector and seasonal workers?
i) How can workers actively participate in non-occupational funds?
j) Would a UK NEST-like scheme work in South Africa?

CONSOLIDATION AND GOVERNANCE

k) How can government facilitate increased consolidation of retirement funds?

ANNEXURE A: Auto Enrolment Proposal

Auto Enrolment[16] seeks to address the lack of retirement savings by a high number of South African workers who fall outside occupational schemes, and are not covered in any retirement scheme, either because they work in sectors of the economy that are non-unionised, or are temporary or contract workers or work in the gig economy (e.g., uber drivers). It is estimated that around 30 percent of workers in the formal sector are currently not participating in a retirement fund. This is mainly due to the voluntary nature of the South African retirement system in relation to joining a retirement fund. Currently, unless provided for in Sectoral Determinations, Bargaining Council Agreements or as a condition of employment, employers do not need to establish or participate in retirement funds. However, many large and medium-sized employers have established and participated in self-standing occupational funds or participate in umbrella funds, in respect of which both employers and workers contribute. There is, however, a significant number of workers who are not members of retirement funds due to them being either employees of small companies, low-income workers, seasonal workers, part-time workers, informal sector workers, independent contractors, sole proprietors, probationary employees, etc. (generally referred to as “vulnerable workers”). It is against this backdrop that Government proposes introducing auto-enrolment to cover a broader spectrum of all formal employees, thereby improving the retirement coverage in South Africa and providing risk cover for such employees on a group basis and enabling workers to build a “nest” for retirement.

Covering informal, seasonal or low-income workers, as examples, always poses a challenge for many systems globally, as retirement savings tend to be built around salaried/wage-based employees formally employed in the public and private sector, who can make regular and fixed contributions. In this regard, many countries tend to leave out vulnerable workers from the formal compulsory retirement systems, while others have used technology in the form of micro-pensions, which rely on FinTech (e.g. Mbao in Kenya and Ejo Heza in Rwanda).

In this regard, auto-enrolment tends to work well for formal salaried employees with the presence of an employer. This could be the first step in extending coverage in South Africa. The next step could be the informal or vulnerable sector, whereby a more voluntary system backed by strong (tax) incentives, FinTech and a default fund, could be a practical solution.

An alternative to auto-enrolment is mandatory coverage of all employees starting with formal sector workers and thereafter progressing to include informal sector workers.

Government will in this regard, propose legislation to compel all employers to deduct contributions to an occupational fund or another approved fund, for all their employees. Employers would not necessarily be required to establish new funds, following Government’s policy intention to reduce

[16] Auto-enrolment: making the employer enrol all employees in a workplace pension scheme or another approved scheme, to which the employer must make a minimum contribution; employees have the option of opting out of the scheme

the number of funds and foster consolidation. Employers would, therefore, enrol their employees into existing funds, which would have to bid for the provision of retirement services or products.