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Social Security and Retirement Reform

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Chapter 1: Introduction and Background

1.1 Introduction

1. The provision of income security is amongst the most practical expressions of a nation's cohesion and values. It relies on confidence in the long-term continuity of institutions. It rests on trust in the law and sound financial and economic management. It embodies the core principles of solidarity and risk-sharing.

2. The process of social security reform announced by the President in his State of the Nation Address on 9 February 2007 is a confirmation of the democratic government's commitment to its vision of a caring and poverty-free society.

3. The President indicated that the Minister of Finance would provide further details on a contributory earnings-related social security arrangement, informed by the principle of social solidarity. Chapter 6 of the 2007 *Budget Review* provides an outline of the proposed social security reforms, and an overview of the present social assistance grant programmes and social security funds. These reforms are aimed at directly attacking poverty by reducing income vulnerability while also supporting employment creation. This discussion paper elaborates on these high-level proposals, with particular reference to retirement reform.

4. The proposed social security and retirement reforms have their roots in the following processes:

   - The 2002 Report of the Committee of Inquiry into a Comprehensive System of Social Security for South Africa;

   - The 2004 National Treasury *Discussion Paper on Retirement Reform*; and

   - Research undertaken on behalf of the FOSAD Social Sector Cluster task team on comprehensive social security.

5. Although certain features of the South African social security and retirement funding system compare well with both developed and developing countries, other features are unsatisfactory. The 2002 Report of the Committee of Inquiry into a Comprehensive System of Social Security for South Africa – *Transforming the Present, Protecting the Future* – provided a thorough review of strengths and shortcomings in the present social protection arrangements, and outlined recommendations for broadening social insurance and implementing a "comprehensive and integrated medium- to long-term framework for income support." The Committee Report also discussed options for extending access to health insurance, and improved alignment between the public and private health care delivery systems. Although beyond the scope of the present discussion paper, reform of income security arrangements provides a platform on which future social health insurance reforms might also be constructed.

6. Arrangements for income security in old age, unemployment insurance, protection of families in the event of death, disability or illness of breadwinners, have evolved from a long history of racial discrimination, institutional fragmentation, awkward divisions of responsibility between government and the private sector and uneven progress towards recognition of workers' rights. There have been considerable improvements, yet there are still substantial gaps in the social security environment, in part associated with the parallel existence of developed and emerging components of our economy.

7. There is a large private pensions sector, built on a well-established legal framework, sophisticated institutions and deep financial markets. The regulatory framework within which private pensions operate is broadly consistent with international standards. Even in the absence of compulsory contributions, coverage levels amongst the formally employed are comparatively high. For those who reach retirement age without a funded pension benefit, the social old age grant provides an assured minimum monthly income.

8. The Unemployment Insurance Fund provides limited income protection to those with a record of formal employment, and there has been some progress in job creation through public works programmes. But there is still a substantial income security gap in the labour market, particularly for work-seekers without past employment experience. Both the benefit structure and administration of occupational compensation arrangements are in need of further overhaul.

9. There are also evident shortcomings in the quality of privately funded life and retirement coverage, and regulatory supervision has not fully kept pace with developments in the industry. Coverage of wage earners is incomplete, and savings vehicles available to the self-employed appear to be more costly than comparable arrangements in other countries. The quality of coverage is further undermined by high levels of "leakage": too many people buy products that they surrender before maturity, and too many workers cash in their accumulated benefits when they

change employment. A lack of transparency, weaknesses in governance of some retirement funds, and limitations on the supervision and enforcement capacity of the authorities have all contributed to sub-optimal protection of members' and pensioners' interests.

10. More fundamentally, the existing structure of retirement provision in South Africa suffers from a serious fracture. The retirement funding environment has two separate fiscal pillars – a social old age grant that supports the poor and a tax-incentivised private pensions sector that provides greater fiscal incentives to higher-income individuals than to low-income individuals. The means test applied to the social old age grant implies that low-income earners are in fact penalised for saving. Nor is there adequate risk-pooling or control of costs in the savings and insurance vehicles available to low-income households. Retirement saving by the poor carries the dual burden of being eroded by costs and risk of loss of social benefits. This has the effect of a "poverty trap": fiscal support for saving and income protection for the poor diminishes as their income rises, while the tax incentive for higher-income groups rises in value as lifetime income increases. The structure of retirement funding in South Africa, in effect, sharply separates the first and second economies, and reinforces this divide.

11. The net result is that more than two-thirds of South Africans reach retirement age without a funded pension benefit and rely mainly on the social old age grant. Moreover, inadequacies in the wider social insurance framework lead families to rely on the old age grant or disability payments as a source of support for vulnerable children and grandchildren.

12. The challenge for reform is to build on the positive aspects of the existing system for social security and retirement funding to establish a more comprehensive and inclusive framework in which saving, risk-pooling, self-reliance and social solidarity will be more firmly rooted.

Key proposals:

13. The proposed social security and retirement reforms will see the introduction of a multi-pillar system, consisting of:

- Social assistance grants, funded from general government revenue, with the means test threshold either removed or significantly increased, providing a safety net against poverty in old age, and providing basic support to the disabled, children and care-givers;

- Mandatory participation in a national social security system, up to an agreed earnings threshold, providing basic retirement, unemployment, death and disability benefits. This will aim to close the wide gap that exists between social assistance grants and current private sector provision.

- Additional mandatory participation in private occupational or individual retirement funds, for individuals with earnings above the threshold, ensuring that individuals at all earnings levels make appropriate provision for insurance coverage and income replacement in retirement.

- Supplementary voluntary savings, permitting individuals to choose how they allocate income over their lifetime.

14. This will be supported by the following reforms:

- A wage subsidy to offset the costs of social security contributions for low-wage employees and to encourage employment creation.

- Administrative reforms to enable the South African Revenue Service (SARS) to maintain individual contributor records and to ensure efficient and reliable benefits administration.

- Complementary reforms of the governance and regulation of the retirement fund industry, which will continue to provide occupational and individual retirement funding arrangements to supplement the basic social security scheme.

- Reforms to the tax system which will seek to maintain sufficient incentive to provide adequately for retirement, while addressing inequities and complexity in the current system.

15. An Inter-Ministerial Committee (IMC) has been formed to lead the process of social security and retirement reform within government, chaired by the Minister of Finance, and including the Ministers of Social Development, Labour, Health and the Minister in the Presidency.

16. The proposals outlined in this discussion paper will form the basis for consultation with the organised business sector, trade unions and other stakeholders during the course of 2007.

17. Further details on associated reforms of the retirement fund industry will be the subject of technical papers to be released during March 2007.

1.2 The South African retirement funding landscape

18. An assured minimum income in old age is provided to men over the age of 65 and women over 60 by the social old age grant. It is subject to a means test, which in turn is linked to the maximum monetary value of the grant. Social grant regulations effectively tax non-grant income at a 50 per cent rate, although in practice there are few old age pension beneficiaries who receive less than the maximum grant value

(R870 a month in 2007/08). Research confirms that the old age grant significantly alleviates poverty among the elderly and many of their dependants.

19. There are more than 13 500 private pension funds, including occupational pension funds, provident funds and retirement annuity (personal plan) funds. Approximately 80 per cent of funds have less than 100 members, which adds considerably to the regulatory workload and raises challenges relating to administration costs, risk-pooling and governance arrangements. There is also considerable concentration in the industry: some 1 million government employees are members of the single largest pension fund, and the 88 largest private-sector funds account for about 73 per cent of private-sector members and pensioners.

20. Financial Services Board (FSB) statistics indicate that there are about 9 million members of retirement funds. However, there is some double-counting in this number because members can belong to more than one fund. The coverage rate for formal-sector employees is estimated to be in the region of 60 per cent. This is comparatively high, even relative to countries with compulsory participation, and it reflects the extent to which membership of an occupational fund is accepted as an obligatory condition of employment. The ratio of pension fund assets to gross domestic product (GDP) in South Africa is about 63 per cent, which compares favourably with countries such as Australia, Chile, Malaysia, Singapore and the United Kingdom.

21. However, the aggregate figures mask several unsatisfactory features of retirement fund coverage. Limited access of lower-income employees or the self-employed to cost-effective retirement vehicles, combined with early withdrawals, contribute to inadequate savings accumulation over working people's lives. A recent industry survey[1] suggests that preservation of accumulated funds among those under 40 years old is less than 10 per cent, and may be as low as 1 per cent amongst low-income members. This contributes to inadequate income replacement at retirement. It is estimated that more than half of those who reach retirement age with a funded pension receive a retirement income that is less than 28 per cent of their pre-retirement income.

22. As in many jurisdictions, the costs associated with private pensions have increasingly come under scrutiny. This has in turn led to regulatory reforms, greater transparency, and standardised disclosure. Improvements in market structure and competition in the retirement funding industry also play a key role in ensuring that the interests of members and pensioners are protected.

[1] *Member Watch (Issue 1),* Alexander Forbes, 2006

1.3 Principles of social security and retirement reform

23. How ordinary people's income security beyond their working years is provided for is a primary expression of society's long-term institutional stability, integrity and social solidarity. Social security and retirement funding arrangements can be thought of as organised around two complementary objectives. The first is assurance of a basic standard of living and prevention of destitution in old age, or in circumstances of unemployment or incapacity, which relies partially or fully on *redistributive* measures. The second is about encouraging saving to provide for income replacement in the event of death or incapacity, and after retirement from the workplace, through long-term *insurance* arrangements. These two objectives can be pursued through separate or integrated schemes, in various ways, and there is considerable variation internationally in the balance between these aspects.

24. There are good reasons for building a new social security framework on the reform of the elementary retirement funding arrangements. The basic funding and administration arrangements for retirement can in turn provide a platform on which other basic social benefit arrangements can be developed, such as death and disability benefits and health insurance.

25. Many countries that have relied predominantly on mandatory state-run funding and administration in the past have sought to encourage parallel or supplementary private saving and insurance markets. The effects of ageing populations and rising costs of health care have led to concerns about sustainability and affordability, particularly in developed countries. Reform in these countries is about bringing greater diversity and private-sector participation into systems dominated by a mandatory earnings-related pillar. On the other hand, most of the world's poor have no access to social security, and current reform efforts in many developing countries are focused on basic social assistance to alleviate survival-threatening poverty and vulnerability.

26. While international experience carries important lessons, South Africa's social security reform challenge is unusual in several respects. A redistributive social assistance programme is in place and there are well-established occupational and individual retirement funding schemes, but South Africa lacks a basic, pooled, mandatory contributory system.

27. The broad principles proposed for these reforms are the following:

- *Equity* – fair and equitable rates of contribution and benefits for all participants.

- *Pooling of risks* – collective funding arrangements and non-discriminatory rules and entitlements.

- *Mandatory participation* – compulsory participation of employees and the self-employed in the formal sector, and encouragement of voluntary participation by those in the informal sector.

- *Administrative efficiency* – streamlined use of payroll-based contributions, modern information systems and efficient payment arrangements.

- *Solidarity* – minimum benefits assured through continued social assistance grants programmes financed through the budget.

28. Social security and retirement reform is not just about the introduction of a new pooled contributory arrangement, but will also involve further steps in extending social assistance programmes, and improvements in the occupational and individual savings and insurance system. These sets of arrangements are complementary and need to be properly aligned and mutually reinforcing.

29. A primary reform objective is to provide basic income protection for all South Africans through a combination of social assistance and contributory savings and insurance arrangements. The aim is to close the gap between, on the one hand, poverty relief measures and social grants programmes, and on the other the tax incentivised long-term insurance and savings environment, which provides inadequately in certain respects for low-wage and irregular employees.

30. Encouraging occupational and individual savings and long-term insurance remains an important second objective of government policy. Adequate income replacement in the event of death or incapacity, or after retirement, above the basic levels provided through social assistance and social security is best promoted through a cost-effective, well-regulated retirement fund industry, taking advantage of private-sector capacity, innovation and competition.

31. Government therefore recognises the advantages of a multi-pillar approach to retirement funding, in which income protection is primarily promoted through standard social assistance and social security arrangements, and further savings and insurance are encouraged through occupational and individual schemes. These should, in turn, include both mandatory earnings-related minimum standards of protection, and provision for supplementary voluntary savings.

32. International practice suggests that there are four broad criteria against which a social security and retirement system should be assessed[2]:

- *Adequacy* of benefits to the full breadth of the population, sufficient to prevent old-age poverty and to provide a reliable means to smooth lifetime consumption.

- *Affordability*, both within the financing capacity of individuals and of society, and without undue displacement of other social or economic imperatives, or untenable fiscal consequences.

[2] *Old Age Income Support in the 21st Century: an international perspective on pension systems and reform*, Holzmann R and Hinz R, World Bank, 2005.

- *Sustainability*, which refers to financial soundness over an appropriate time horizon under a broad set of reasonable assumptions.

- *Robustness*, including the capacity to withstand major shocks, such as significant shifts in economic prospects or demographic trends.

33. Government's social security and retirement reform proposals are aimed at improving income-security arrangements in relation to these core criteria. The proposals take particular account of the challenge of improving coverage and income-replacement ratios for low-income earners, through the introduction of a cost effective, basic contributory social security system, to complement the redistributive social grants programmes. Alongside this initiative, regulatory and tax reforms to the occupational and individual retirement fund environment are aimed at improving its equity, efficiency and adequacy.

Chapter 2:
A Framework for Social Security and Retirement Reform

2.1 Mandatory participation, standardised administration and minimum risk

34. There is a well-established case for the collective provision of basic insurance against catastrophic events, such as death, disability and unemployment, through a mandatory social security arrangement. Mandatory, universal participation in a pooled social insurance arrangement recognises that those who are most vulnerable will tend to be excluded if participation is subject to choice or selection. If everyone is to enjoy equal, basic protection against life crises, participation has to be obligatory.

35. There are also compelling reasons for mandatory contributions towards retirement savings. While there is widespread acknowledgement of the importance of savings and long-term insurance, in practice the tendency is for individuals to discount risks and future needs, and to defer savings and investment decisions. Evidence suggests that while workers recognise the importance of retirement provision and state an intention to join a retirement plan or to increase their savings, only a small fraction do so in practice.

36. The main implications of behavioural factors in retirement provision are highlighted in the first report of the UK Pensions Commission (2004). These can be summarised as:

- Individuals facing complex and long-term financial decisions often delay those decisions unless some external agent intervenes.

- Individual decisions are heavily influenced by default options, i.e. the action that requires little or no ongoing decision-making, and these can be more effective than information campaigns and advice.

37. A compulsory system administered on a payroll-tax basis also offers advantages of economies of scale in the maintenance of member records and investment management.

38. Against a backdrop of decision-making failures compounded by market failures in the form of high costs of financial services for low-income workers, the case for compulsory savings is convincing. Mandatory earnings-related contributions to public or private schemes are a common feature of pension systems in many countries. These systems typically include both guaranteed minimum benefits (redistributive elements) and entitlements representing long-term insurance benefits, either of a defined benefit or defined contribution kind. Almost all members of the Organisation for Economic Cooperation and Development (OECD), which is

composed of developed and middle income countries, have some form of mandatory earnings-related provision, although the arrangements vary considerably.[3]

39. The proposed introduction of mandatory retirement savings in South Africa is therefore in line with international practice in the development of broad-based pension systems. However, several alternative forms of mandatory provision exist. Most developed countries have mandatory social security schemes established in law and collectively administered. More recently, several governments have sought to supplement or substitute such public provision with mandatory contributions to individual accounts in privately managed pension schemes. Some countries have adopted a system of auto-enrolment, whereby individuals are automatically enrolled in a retirement plan, but can still practice individual choice to "opt-out" if they have more pressing financial needs or wish to transfer to an alternate plan. A variation on this is to allow people to opt-out of a public scheme, provided that the individual or employer participates in a private pension plan that meets approved standards.

40. Taking into account South Africa's present circumstances and priorities, two tiers of mandatory contributions are proposed:

- A mandatory contribution to a national social security fund, up to an earnings threshold, to complement existing redistributive social assistance programmes.

- Mandatory supplementary contributions to an occupational pension fund or individual retirement fund in respect of normal earnings above the threshold, up to a certain monetary ceiling in terms of tax deductibility, to ensure appropriate insurance coverage and adequate income replacement for all in retirement.

41. It is noted that the majority of commentators on the National Treasury's 2004 *Discussion Paper on Retirement Reform* supported the introduction of compulsory retirement provision, citing concerns that a voluntary system of retirement provision would not be sufficient to address the serious problem of the low level of household savings and the tendency for a large proportion of people to reach retirement without adequate provision for themselves or their dependants.

42. It is proposed that the basic social security arrangement should provide for contributions to a low-cost national retirement fund, together with death and disability cover and enhanced unemployment insurance, and provision for administration costs. Administrative arrangements must be straightforward,

[3] Amongst OECD countries, only Ireland and New Zealand do not have either a public or private mandatory scheme based on earnings-related contributions. The most common mandatory arrangement is a public defined benefit scheme (in place in 17 out of the 30 countries reviewed), in which retirement benefits are typically calculated by reference to years of contribution and some measure of earnings, up to an agreed cap. Most, but not all, private compulsory savings arrangements are defined contribution schemes, in which final benefits rely on the investment return on accumulated contributions. (*Pensions at a Glance: Public Policies Across OECD Countries*, OECD, 2005)

standardised and cost-effective, with the minimum of financial complexity or investment risk.

2.2 Employment, wages and social security

43. The 2004 *Discussion Paper* noted that any consideration of compulsory employee contributions to an occupational or individual retirement fund should be mindful of the potential impact on the cost of employment.

44. A key consideration in the South African context is the need to broaden social security while encouraging job creation and protecting the disposable incomes of poor households. Social security financing arrangements that raise the costs of labour or impose an onerous tax burden would be counter-productive.

45. Social benefits can be financed from general revenue, as is the case with the present basic social assistance grant programmes. However, international practice favours earnings-related contributions to social security arrangements, partly because this gives recognition to the economic link between earned income and the affordability of benefits, and because it ties costs to benefits in the wage package itself, which adds real and perceived value to the employment and remuneration contract.

46. In the absence of consolidated social security provision, South African employment arrangements exhibit a variety of uncoordinated benefit schemes, in which practices vary between the public and private sectors, between different categories of employees, between the employed and the self-employed, and between a large number of occupational provident fund and pension schemes.

47. Both retirement and medical scheme arrangements benefit from favourable tax treatment, but for many employees this brings little or no tax benefit as their earnings fall below the tax threshold or are taxed at a low marginal rate.

48. A central argument for the construction of an earnings-related social security framework is that it creates a bridge across the "poverty trap" that separates the present social assistance programmes from the tax-privileged savings and social protection arrangements available to higher-income earners. In a well-designed social security system, the fiscal arrangements are constructed to establish positive links between work, earnings, savings accumulation and household income security. The state underwrites a social safety net, but it also positively rewards work effort, earnings and savings.

49. The key contribution of a basic social protection framework to shared growth is that it reduces the severity of cycles of progress and setback, employment and unemployment, advancement and catastrophe, that otherwise interfere with the efforts of the low-income workers to break out of poverty. Greater income security empowers the poor to seek opportunities that would otherwise be beyond reach, and

to cooperate in income-generating ventures in ways that would otherwise be too risky or that would offer returns in the distant future.

50. Social security systems involve varying degrees of redistribution of income or cross-subsidisation. In exploring options for South Africa, special consideration has to be given to our own history and circumstances. Two features stand out. The first is a high level of unemployment; the second is the related legacy of inequality. Broader social security will be supported by a wage or employment subsidy or cross-subsidy arrangement. This will contribute in the first instance to lowering the costs of employment and raising labour earnings of the poor – not just in traditional public sector employment sectors ("public works"), but also in traded goods and service sectors.

2.3 A wage subsidy proposal

51. Government proposes to introduce an explicit wage subsidy and continuing minimum benefits through social assistance, rather than indirect cross-subsidisation. This approach gives greater transparency to social policy, and allows the social security retirement funding arrangement to be funded (rather than financed on a pay-as-you-go basis). The suggested framework relies, nonetheless, on substantial risk-pooling and redistribution within a common fiscal system, but without the "poverty trap" features of present arrangements.

52. Design options for a wage subsidy will be examined in more detail during the course of 2007.

53. Wage subsidies of one form or another are prominent features of the employment and social protection policies of many countries today. Examples include the family credit system in the United Kingdom, the earned income tax credit in the United State, the tax credit for new job creation in Mexico and the subsidy for social security contributions of low-wage earners in the Netherlands.

54. As an illustrative example, a wage subsidy could take the form of reimbursement to the employer, implemented as a rebate or credit in the PAYE system, calculated in relation to the gross wage paid to employees earning below a threshold of R45 000 a year, as follows:

- For a wage less than R15 000 a year, the subsidy is equal to one-third of the wage
- For a wage of R15 000 a year, the subsidy equals R5 000 a year (maximum subsidy)
- For a wage between R15 000 and R45 000 a year, the subsidy equals R7 500 minus one-sixth of the wage.
- For wages greater than R45 000 a year there is no subsidy.

55. The total cost of such a subsidy would be R20 billion to R30 billion per annum, depending on the extent of coverage. The economic and fiscal impact would be moderated and gradual, however, mainly because the implementation in the form of a credit to employers would increase savings rather than consumption initially and there would be a favourable impact on costs and price trends. A further feature of this model is that it creates an inducement for low wages to rise to a targeted "minimum wage," in addition to significantly reducing the cost of job creation. Above this rate, or above a selected higher threshold, the subsidy automatically phases out as earnings rise.

56. There are various design aspects to consider – the rate structure, how to treat part-time employment and multiple-employer cases, sectoral coverage, whether to include self-employed and informally employed individuals, collection and reimbursement arrangements, data management, controls and self-enforcement provisions. There is a case to be made for more targeted subsidy arrangements, perhaps focusing on particular sectors, or on first-time entrants to the labour market. If the phasing-in of the wage subsidy is linked to the introduction of a social security contribution, it should be broad-based. The rationale for a wage subsidy is not just to encourage employment creation, but also to support a "living wage" in labour-intensive sectors and low-wage occupations. This is a more satisfactory approach to protecting the living standards of working people than relying solely on regulations and industrial relations measures, because it promotes rather than inhibits economic activity.

57. A wage subsidy in this form would contribute over time to employment creation, because it would lower the cost of jobs, particularly in more labour-intensive sectors. But the employment effect would only be fully realised over the longer term because it requires firms to change their expectations and investment decisions. The short-term effect is a redistribution of income in favour of low-wage workers and their employers, together with the intended change in the affordability and incentives surrounding social security participation.

2.4 Social security contributions and benefits options

58. A wage subsidy makes it possible to introduce a social security financing arrangement as a standard payroll deduction, without imposing an employment-reducing burden on the labour market.

59. The features of such a social security financing arrangement require further discussion with stakeholders during the course of 2007. Initial proposals are outlined below.

Coverage

60. It is proposed that mandatory contributions to the national social security arrangement be made universal, encompassing all formal sector employees. Compulsory contributions by household employees and the self-employed would be phased in over time.

61. To moderate the impact on disposable income of lower-income workers, it is proposed that a wage subsidy be instituted at the same time as mandatory contributions. For low-income workers, the wage subsidy would cover the costs of social security contributions.

62. Consideration also needs to be given to encouraging voluntary participation by those working in the informal sector. The 2004 *Discussion Paper* introduced the idea of a National Savings Fund that would serve as a cost-effective savings vehicle for low-income earners and informal sector workers. With the proposed introduction of a comprehensive social security system, the feasibility of allowing for irregular, voluntary contributions to an individual savings account within the national social security scheme should be examined. Provision for early withdrawal of accumulated voluntary savings may need to be accommodated, to take account of life crises, but with due consideration to the need to encourage preservation.

Contribution structure

63. The present old age grant will continue to be funded from general revenue, and will remain in place as a non-contributory retirement income "floor". However, consideration needs to be given to abolishing the means test or shifting the thresholds out considerably, allowing the basic old age grant to be enhanced by a supplementary pension purchased out of accumulated individual retirement accounts. In this way, the administrative capacity of the present social security system can be used to disburse supplementary pension benefits and working people can be provided with an efficient and secure means of preserving retirement benefits over and above the basic income security of the social assistance grant system.

64. It is proposed that contributions out of earnings to retirement and risk benefits should comprise three parts:

- A universal, mandatory contribution to the national social security fund, up to an earnings ceiling;

- A mandatory supplementary contribution to an occupational pension fund or individual retirement fund for individuals above the earnings ceiling, up to a monetary cap, which fulfils an insurance role in terms of helping to ensure an adequate replacement rate for all in retirement; and

- Additional voluntary contributions to an occupational or individual retirement fund.

65. This will require several adjustments to earnings and benefit arrangements to be phased in over time. Present pension arrangements will have to be adapted to include a standard social security element and a supplementary occupational benefit.

66. Consideration should be given to allowing existing pension and provident funds to make single-premium transfers to the credit of the individual accounts of their members in the new national social security fund, subject to an agreed set of rules and procedures designed to ensure a fair and equitable transfer of members' interests, without loss of accumulated benefits, and on the understanding that such retirement funds could continue to collect contributions as "top-up" occupational or voluntary plans, in addition to the basic social security arrangement.

Contribution rate

67. The appropriate rate and composition of a social security contribution depends on what benefits it is to finance. International practice suggests that a rate of between 13 and 18 percent of an after-tax wage (equivalent to between 11,5 and 15 percent of a before-tax wage) would be required to finance basic retirement savings, disability and death (survivor) benefits, unemployment insurance and administrative costs. The benefit design will have to take careful account of demographic trends and the potential impact of HIV and AIDS.

68. Social health insurance is more complicated in design and there are a wide range of approaches adopted internationally. If it is to be financed through a standard social security contribution, the rate of contribution would need to be higher – perhaps 20 to 25 percent. But the financing system for health services is the lesser part of health system reforms: the quality of health care services and greater integration between public and private sector arrangements present more formidable challenges. The present fiscal framework already provides for a substantial health care system, administered by provinces and financed through the budget. Options for the evolution of health care financing and service delivery require in-depth analysis and broad consultation.

69. In the transition to a mandatory social security arrangement, both the proposed wage subsidy and offsetting changes to existing employee benefits and taxes on earnings would be structured to protect the disposable incomes of taxpayers.

Contribution ceiling

70. Internationally, mandatory social security contributions are typically capped at a level that is adjusted from time to time for inflation or average earnings increases. The mandatory contribution to the national social security fund could be limited to

earnings below the present Standard Income Tax on Employees (SITE) threshold of R60 000 a year, or it could be extended to a higher earnings threshold.

71. Provision can be made for voluntary supplementary contributions. This would allow individuals to invest their total minimum mandatory contributions within the national social security fund as an alternative to participation in a supplementary private pension fund (for example, where the earnings level is just over the earnings threshold), or to make up for an inability to save across a period of unemployment.

Funding

72. Modern data management techniques make it administratively practical for retirement funding contributions to accumulate in individual accounts and to be credited with a standard real return on investment, effectively providing a secure mandatory savings arrangement in which all contributors share a common administrative platform and a pooled common rate of return on savings.

73. Compulsory preservation will apply to mandatory contributions.

Administration and fund management

74. Social security administration and fund management functions are undertaken as government agency responsibilities, in most countries. However, some countries have adopted private sector management arrangements and competitive provision of services, subject to specification and regulation of product design and cost structures. These and other design options will be the subject of research and consultation during 2007.

2.5 Consolidated administration of benefits

75. Separate social security funds are presently in place to finance unemployment benefits including maternity leave benefits, compensation for occupational injuries, diseases and death and compensation to victims of road accidents. All of these arrangements have come under review and are in need of administrative re-engineering.

76. UIF contributions are now mainly collected by SARS, which has contributed to improved compliance and better data integrity. Enhancing the capacity of SARS, and improving its systems to manage individual accounts records, is a precondition for implementation of the proposed social security reform.

77. There are several advantages in consolidated administration of basic social benefits. These include direct control over a comprehensive database; economies of scale in administration, payments and data processing; and simplicity and accessibility for beneficiaries. This does not preclude contractual employment of private sector

administrative capacity, but it allows for standardisation of systems and integrated fraud control arrangements.

78. Over the medium term, Government needs to give consideration to consolidation or improved alignment between its various income support and social benefit administrations – social grants, UIF, the Compensation Funds, and the Road Accident Fund.

79. The consolidation of social grants payments under the new South African Social Security Agency is an important step forward. However, the administrative business model currently employed – including regional outsourcing of payments to service providers associated with either commercial banks or the Post Bank – should in due course give way to more modern and cost-effective arrangements. Early initiation of the work that needs to be done to develop an administrative model capable of maintaining individual retirement accounts, a range of social security benefits and more flexible low-cost payments arrangements is a key requirement for progress with the larger reform project.

2.6 Concluding note

80. Government proposes to introduce a broad-based social security framework over the 2007-2010 period, as a further step in strengthening labour market institutions and improving income security of low-income employees. More detailed plans and options will be tabled for discussion with stakeholders during the course of 2007.

81. The creation of a comprehensive social security system will involve large fiscal and institutional adjustments. The organisational and transitional challenge is to make these adjustments in ways that have positive effects on household welfare, employment and income security, without undue disruption of the financial sector or the public finances. Over time, social security reform will have progressive and lasting redistributive and poverty-reducing effects, through reduced household vulnerability, encouragement of work effort, saving and accumulation and a fairer fiscal regime.

82. At its broadest level, this approach aims to build a bridge over the “poverty trap” features of the present fragmented social security framework, by supporting and encouraging household saving, accumulation and income progression, while providing for a broad-based, affordable, collective pooling of provision for life-cycle risks.

Chapter 3: Private Pensions Reform

3.1 Introduction

83. The proposed social security and retirement reforms are intended to ensure that all South Africans receive at least a basic level of retirement and insurance benefits through a combination of social assistance and a contributory social security arrangement. However, this will not meet the full retirement and insurance needs of all individuals. For higher-income employees, adequate income replacement in old age or disability, or prudent provision for dependants in the event of death, will necessitate supplementary contributions to an occupational pension fund or individual retirement fund. This will be mandatory up to a point, after which voluntary contributions will be encouraged through tax incentives up to a monetary limit.

84. Retirement reform seeks to tackle the structural deficiencies in the current system, while building on existing strengths in the private retirement fund sector. South Africa's retirement fund industry is supported by a wide range of sophisticated service providers, in areas such as administration, actuarial services, employee benefit consulting and investment management. In reform, it is necessary to harness this existing capacity and build on the foundation laid by private sector retirement provisioning. Ensuring and maintaining a strong, cost-effective and well-regulated private pensions sector is thus a critical element of South Africa's overall retirement funding strategy.

3.2 Background

85. In December 2004, the National Treasury released a *Discussion Paper* on retirement reform for public comment, focusing in particular on reform of the private pensions sector, including aspects of governance, regulation and the protection of member benefits. A considerable volume of commentary was received and the principles contained in the *Discussion Paper* were extensively debated with a wide range of stakeholders.

86. Finalisation of the National Treasury's proposals with respect to reform of the regulatory framework and tax treatment of the private retirement fund sector has taken longer than expected because of the need to consider such proposals within the context of broader social security reform.

87. The structural challenges and proposed reform of the social security and retirement funding landscape, outlined in Chapters 1 and 2, have guided further thinking on proposed changes to the private pensions regulatory and tax environment. Revised regulatory proposals, and consideration of supporting tax changes, will be published separately during March 2007. Areas that require particular attention in respect of

member benefits, governance and regulation are summarised in the discussion that follows in the rest of this Chapter. Initial thinking on accompanying tax changes is contained in Chapter 4.

88. Significant changes and additions to reform proposals since the 2004 *Discussion Paper* include:

- Replacement of the proposed standalone National Savings Fund for low-income and informal workers with the proposed integration of contributions from such individuals into a comprehensive social security system, which will provide low-cost, secure access to basic retirement and insurance benefits.

- Introduction of mandatory retirement savings and preservation, to overcome the inadequacies of a voluntary system, which follows general support for such a measure from the vast majority of stakeholders.

- Complementary reforms to the tax system designed to maintain sufficient incentive to provide adequately for retirement, while addressing inequities and complexity in the current system.

89. Various concerns relating to unfair practices, poor governance and high costs in the retirement fund industry have come under the spotlight in recent years. This is largely a legacy of non-disclosure, opaque products, inappropriate sales techniques and a lack of effective competition – all exacerbated by poor financial literacy.

90. To address some of the most pressing inequities and inadequacies in the current system, various legislative and regulatory measures have been, or are being, put in place in advance of broader reform measures:

- In December 2005, the Minister of Finance and representatives of the life industry signed a Statement of Intent (SOI), that committed life companies to make both restitution for inequities of the past and to improved standards of disclosure, product simplicity, investment value protection and commission regulation. The SOI makes specific restitution for policyholders who suffered extreme penalties as a result of having surrendered, made paid-up or reduced their premiums on retirement annuities. Regulations giving effect to the SOI were gazetted in December 2006.

- In March 2006, a *Discussion Paper on Contractual Savings in the Life Industry* was published by the National Treasury outlining measures designed to increase effective competition, lower costs and improve member protection (such as enhanced minimum early termination values). These measures are linked to a review of commission regulations, as the current system of upfront commission payments on the savings products of the life industry is a substantial component of overall cost and encourages mis-selling. Proposals include a shift to a more as-and-when basis of commission payment, conditional on ongoing service. This is expected to better align the interests of the intermediary with those of the client. Regulations to give effect to these proposals will be promulgated during the course of 2007. These reforms will complement earlier reforms such as the Financial Advisory and Intermediary Services Act (2002), which improved disclosure and imposed fiduciary duties on those individuals who provide advice to consumers.

- Conflicts of interest in pension fund administrators, specifically undisclosed profits arising from the practice of "bulking", were the subject of investigations by the Financial Services Board and a Parliamentary hearing in June 2006. It was revealed that in some cases pension fund administrators had not passed on to the fund all or part of the benefit (in the form of higher interest income) of bulked deposits, and did not always disclose such practice to the fund's board of trustees.

- A Pension Funds Amendment Bill was approved by Cabinet on 7 February 2007 for forwarding to Parliament for consideration during the first half of 2007. The Bill increases the powers of the Registrar of Pension Funds, in particular to deal with instances of conflicts of interest, and poor governance among trustees, administrators or service providers. The FSB has also released a draft Code of Conduct for pension fund trustees.

- Lastly, high costs and inequities in the contractual savings environment are worsened by complex products and poor consumer education. As part of the Financial Sector Charter's broad-based approach to black economic empowerment, financial sector firms have committed to the following: investing 0,2 percent of pre-tax profit in consumer education initiatives; developing banking, savings and insurance products that are appropriate, accessible, understandable and affordable for low-income households; and promoting pension fund trustee activism, including commitments to socially responsible investment (SRI).

3.3 Key regulatory challenges

91. Achieving adequate income replacement in retirement is a function of a number of variables, including years of contribution, rate of contribution and investment performance, combined with the avoidance of erosion of accumulated savings caused by early withdrawals, excessive costs of administration or obtaining an annuity, and inadequate protection of member benefits.

92. A frank assessment of the current South African retirement savings landscape suggests that while many people in formal sector jobs contribute to retirement funds, the vast majority start too late in their careers to save enough for retirement, or cash in their retirement savings when they change jobs. Rates of contribution appear reasonable on average, but are increasingly being eroded by rising administration

costs and risk premiums. The high proportion of defined contribution (DC) retirement funds in the private sector means that the risks of governance failures, expense inflation and inadequate benefit protection fall on the individual member, who is often least equipped to manage or withstand the loss.

93. Improving the quality of private pension fund provision in South Africa, in terms of lowering costs and improving equity, will require reforms, including:

- Facilitating effective competition, through improved transparency and disclosure, properly-aligned incentive structures, and removing regulatory barriers to the entry of a wider range of product providers;

- Achieving economies of scale, through the possible introduction of accreditation standards and minimum regulatory requirements for funds, which may encourage the consolidation of smaller occupational pension funds into multi-employer or industry funds;

- Protecting the value of retirement benefits accruing to members through minimum allocations to retirement savings, compulsory preservation and portability, regulated minimum early withdrawal benefits and restricted deductions;

- As far as possible, ensuring a continuing source of income during retirement or disability or for the member's dependants after the member's death, by requiring that a portion of member benefits is used to obtain an annuity income, improving the cost-effectiveness of annuity products, promoting the protection of the value of pensions against inflation, and improved oversight of payments to dependants; and

- Improving standards of fund governance and supervision, so as to address fraud, conflicts of interest and exposure of fund members to excessive risk.

94. Areas requiring further thought in this regard and possible areas for reform are summarised below. Specific proposals will be published for comment in March 2007.

3.4 Structure of the private pensions market

95. Recent studies have indicated that the cost of retirement fund arrangements in South Africa is high relative to international benchmarks. While occupational retirement funds appear slightly expensive overall, retirement annuity products offered by the

long term insurance industry appear to be very expensive when assessed both against local alternatives and international benchmarks.[4]

96. One way in which effective competition among product providers can be increased, with a view to lowering the costs of retirement savings products, is to permit a broader array of providers, including collective investment scheme managers and banks to enter the market for "savings-only" individual retirement funds. A level regulatory playing field will have to be provided across various services providers.

97. Clear, standardised disclosure – combined with the individual right to transfer between funds without undue penalty – can further assist in bringing down costs. In order to avoid potential mis-selling by intermediaries, careful thought will have to be given to intermediary incentive structures, possibly excluding commission charges on such transfers, but enabling the member to authorise payment of an advice-related fee to an independent financial advisor.

98. Other cost issues relate to the fragmented structure of the private pensions market. With over 13,500 funds in existence, 80 per cent of which have less than 100 members, concerns arise as to the cost-effectiveness of administration and regulation for smaller funds. Larger funds tend to benefit from economies of scale in administration and are better able to meet regulatory requirements without imposing an excessive burden on members. Some consolidation of smaller funds into industry or multi-employer ("umbrella") funds, or through transfer of member benefits on an equitable basis to the national social security fund, may assist in this regard. While policymakers and regulators tend not to favour explicit price regulation, such as caps on charge ratios, because of the complexity and potential unintended consequences of such measures, some steps such as requiring a minimum number of members in a fund, may encourage positive market adjustments over time.

99. Further research and consultation will be required on appropriate governance and member representation arrangements for umbrella funds and savings-only individual retirement funds.

3.5 Member benefits, portability and preservation

100. Most occupational pension funds provide death and disability benefits in addition to their main purpose of providing a benefit on retirement. Some provide for a subsidy of the medical aid contributions of members after they retire. These ancillary benefits have played a significant role in providing income security to the employed,

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[4] Annual equivalent reductions in yield (the degree to which investment returns are reduced) were estimated to be between 1.8% and 2.9% over a 40-year saving period for these products. This compares poorly with reductions in yield of 1.2% to 1.4% calculated for the equivalent product in the United Kingdom, namely the personal pension, a product that is regarded in that country as being unnecessarily expensive. (*Costs of Saving for Retirement: Options for South Africa*, Rusconi, R., 2004)

in the absence of a comprehensive social security system, though not on a consistent basis across contributors.

101. While the main purpose of retirement funds is saving for retirement, the cost and risk pooling benefits of obtaining group risk cover through a retirement fund are such that it is considered desirable that the design of occupational pension funds should continue to be able to include a supplementary package of benefits appropriate to the member profile of the fund, over and above the basic insurance benefits provided by a social security contribution. The range of risk benefits that can be accommodated within a retirement fund should be complementary to those to be covered by a national social security fund and could include death, permanent and temporary disability, funeral benefits and provision for post-retirement medical aid subsidies.

102. However, the introduction of universal, basic social insurance benefits will imply that the scale of benefits that occupational funds provide to their members may need to be adjusted over time. Furthermore, the recent trend of rising risk premiums and administration costs should not be allowed to erode the savings component of retirement fund contributions. Consideration needs to be given to measures to ensure that occupational funds include a meaningful minimum retirement savings component.

Preservation and protection of benefits

103. Previous commissions of enquiry into retirement funding in South Africa identified poor early leaver benefits, and the payment of such benefits in cash, as the most important reasons why so many people retire with inadequate benefits. Even small amounts accumulated early in a person’s working life can make a significant difference to retirement incomes if reinvested over a number of years.

104. The proposed introduction of mandatory minimum contributions to retirement saving requires a corresponding limitation on the early withdrawal of such funds, given the objective of providing an adequate income in retirement. This implies compulsory preservation of benefits on change of employment, through transfer to either the new occupational fund in which the employee will participate or to an individual retirement fund – or possibly even to the national social security fund.

105. The majority of the commentators on the 2004 *Discussion Paper* shared this view on compulsory preservation. Concerns were raised, however, about the feasibility of compulsory preservation in a situation where a person loses his or her job and faces pressing financial needs. Consideration therefore needs to be given to the possibility of allowing a partial drawdown of retirement benefits in the event of a loss of employment, and how this would interface with unemployment insurance benefits.

106. A compounding problem is that retirement savings may also be eroded if they are not protected from the deduction of excessive costs and the imposition of penalties

on early withdrawal or, in the event of retirement annuity funds, early termination of the underlying fund member policy.

107. Poor early withdrawal benefits have been largely addressed through the minimum benefit legislation enacted as part of the Pension Funds Second Amendment Act, 2001. The Pension Funds Amendment Bill to be tabled for consideration by Parliament shortly will address certain technical loopholes. Minimum early termination values to be received by members of retirement annuity funds were addressed in 2006 through regulatory changes that gave effect to the Statement of Intent signed between the Minister of Finance and the life industry in December 2005. These minimum early termination vales are to be enhanced during the course of 2007, following the implementation of revised commission regulations covering the sale of contractual savings in the life industry.

Payment of benefits

108. The purpose of a retirement fund is to produce sufficient income during retirement, disability or for the member's dependants after the member's death. Payment of the full benefit in the form of a lump sum seldom serves this purpose, especially as people who retire in good health tend to underestimate their longevity.

109. As a result there are strong policy arguments favouring the payment of benefits in the form of an income after retirement, disability or death. However, it is also recognised that there are advantages in permitting individuals or dependants access to a limited lump sum upon retirement, disability or death of a breadwinner, such as for settling outstanding debt.

110. Currently, pension funds are able to pay up to one-third of a retirement benefit in the form of a lump sum, with exceptions from this limit for amounts below a certain threshold. No restrictions currently apply to benefits received from provident funds.

111. With the proposed standardisation of regulatory and tax treatment of all forms of retirement funds, it is proposed that a consistent approach be applied to the payment of retirement, death and disability benefits by pension, provident and retirement annuity funds. Regulations should allow for the payment of a modest proportion of the benefit in the form of a lump sum, with the balance being used to secure a conventional annuity, except for benefit values below a certain threshold. Transitional arrangements will be necessary in the case of provident funds.

112. Consideration could be given to creating an exception which allows for an increase in the lump sum proportion, or the purchase of income drawdown products ("living annuities"), provided that sufficient capital remains to secure a conventional annuity amounting to a specified multiple of the social old age pension.

Annuities on retirement

113. In the context of the policy preference for the payment of benefits in the form of an income after retirement, it will be crucial to ensure that there is effective competition in the annuity market and that the costs of annuities are not excessive.

114. Generally, annuities on retirement are purchased from an insurer – either by a pension fund on behalf of the member or by the retiring member themselves. Some large pension funds provide pensions directly. Policy issues for consideration include whether regulation should facilitate the wider provision of annuities directly by pension funds, or whether an annuity provided by the proposed national social security fund could serve as a useful benchmark in this regard.

Death and survivor benefits

115. The 2004 *Discussion Paper* attempted to find a path through the sometimes complex protocol that is required of retirement fund trustees in ensuring that the disbursement of death benefits to dependants takes place on an equitable basis. In the light of comments received, regulation must seek to find a balance between the social service provided by trustees in exercising their investigative and distributive functions on the one hand, and the need to ensure the simple and speedy disbursement of benefits on the other.

116. Another key concern, in the light of recent developments, is the security of funds placed with widow and orphans' trusts ("umbrella trusts") and the level of oversight over how these funds are invested and managed. Measures to improve the protection of dependants' benefits could include the establishment of dedicated "caretaker funds" regulated by the Financial Services Board.

Unclaimed benefits

117. Some retirement fund benefits remain unclaimed, either because the fund's records are inadequate to facilitate tracing former members or their dependants, or because members may have failed to maintain contact with the fund or employer.

118. While member education, better record-keeping and beneficiary nomination are needed to minimise such situations, an efficient and cost-effective way to deal with the legacy of unclaimed benefits could be the establishment of an Unclaimed Benefits Fund, tasked with tracing former members or dependants to whom a benefit is due but has not been paid. Certain governance and design issues for such a fund require further consideration and stakeholder consultation, but indications are that it should be established as a public entity, and governed specifically by a statute separate from the Pension Funds Act.

3.6 Governance and regulation

119. The history and evolution of private and public pension funds in South Africa has led to a haphazard legislative landscape, in which various funds fall under different acts and regulators. This compromises the goal of member protection and consistency in areas such as funding standards and dispute resolution. As part of retirement fund reform, a process will be put in place to consolidate the regulation and supervision of all retirement funds under one Retirement Funds Act. As a first step, the Pension Funds Amendment Bill to be tabled in Parliament in the first half of 2007 proposes that bargaining council funds not yet registered under the Pension Funds Act, will be required to do so by 1 January 2008 (or a later date to be determined by Parliament).

120. The regulation and governance of private pensions should also be viewed within the context of the shift away from defined benefit (DB) to defined contribution (DC) schemes that has taken place not only in South Africa but also many countries elsewhere over the past few decades. Under a DC scheme, the risks of worse-than-expected investment returns or higher-than-expected expenses are transferred to the individual fund member.

121. Effective management of such risks by the fund's board of trustees, under the supervision of the regulator, is vital, as members frequently lack the expertise to manage such risks themselves.

122. As discussed above, there have been problems of poor governance, inadequate protection and high costs in the private pensions sector in recent years. These issues are not unique to South Africa. A common global regulatory challenge is the failure of trustees and product and service providers to recognise, disclose and adequately manage conflicts of interest. Particularly evident in countries such as South Africa, where retirement funds operate under a board of management model, is the over-dependence of trustees on third party experts, who are not always motivated by the best interests of members. This seems particularly acute in retirement annuity and umbrella (multi-employer) funds where the sponsor is often also a service provider to the fund.

123. In assessing the adequacy of governance and regulation in the South African retirement funding system, it is possible to benchmark the regulatory architecture against six commonly accepted core principles that should be considered in any regulatory design:[5]

(i) Governance structures, specifically focusing on the duties and responsibilities of those involved in the governance and provision of services to a retirement fund.

[5] As contained in the OECD Core Principles on pension fund governance and regulation.

(ii) Governance mechanisms, such as internal controls within the fund, reporting to regulators, disclosure to members, and appropriate dispute resolution and redress mechanisms.

(iii) Funding rules, specifically focusing on ensuring that defined benefit or hybrid funds are subject to minimum funding rules or alternative mechanisms to back pension liabilities. Other issues requiring attention include appropriate calculation methods for asset valuation and the funding of liabilities, proper winding-up mechanisms, and an evaluation of the need for and the possibility of a pension guarantee scheme.

(iv) Protection of member and beneficiary rights, including non-discriminatory access, the portability of pensions, appropriate member investment choice where it is offered, member recourse outside of the fund, appropriate disclosure to members and member education.

(v) Investment regulation, including aspects such as an integrated assets/liabilities approach, an assessment of quantitative regulations and prudent-expert principles, and the application of up-to-date, effective risk management techniques.

(vi) Effective supervision, focusing on legal compliance, financial control, actuarial examination and the supervision of fund role-players. The pensions supervisor should have sufficient enforcement powers in order to fulfil its mandate.

124. An outline of how these issues might be addressed in the South African context is provided below. Some of these areas are being addressed in the short term through interim amendments to legislation and regulation. Other, more complex issues require further consultation as part of the longer-term retirement reform process. A more detailed discussion of specific proposals is contained in the document to be released in March 2007.

Governance structures

125. Pension fund governance structures should ensure an appropriate division of operational oversight responsibilities, and the accountability and suitability of those with such responsibilities.

126. The model traditionally followed in South Africa is governance and oversight of fund operations by a board of trustees, at least 50 per cent of whom the members have the right to elect. The level of member representation on the board is consistent with international norms, and in fact superior in terms of fund democracy to funds in countries such the United States and the United Kingdom.

127. However, a number of weaknesses in the current model need to be addressed in order to strengthen fund governance. These include improving the level of trustee knowledge and standards of conduct, adopting a more systematic and consistent

approach to trustee training, introducing a role for a compliance officer (which could possibly be an extension of the duties of a fund's principal officer), and addressing conflicts of interest between trustees and their fund, and between trustees and fund service providers.

128. Particular attention, possibly involving further consultation through a technical working group, needs to be paid to addressing governance concerns in multi-employer (or "umbrella") funds, investigating the concept of a corporate trustee model for "savings-only" individual retirement funds, and reviewing the governance arrangements of retirement annuity funds. In addition, there is a need for trustees to interrogate one-stop-shop arrangements in order to properly verify the benefits to the fund and to put appropriate checks and balances in place to mitigate the inherent potential for conflicts of interests in such arrangements.

Governance mechanisms

129. Pension funds should have appropriate internal control, communication, and incentive mechanisms that encourage good decision-making, proper and timely execution of duties, transparency and regular review and assessment.

130. At least four types of governance mechanisms require attention: internal controls, reporting channels, disclosure to members and the regulator, and redress for members and beneficiaries.

131. Inadequate disclosure has been highlighted as a particular concern. Many of the determinations handed down by the Pension Funds Adjudicator in recent years relate to disputes arising from poor disclosure – particularly, though not limited to, the charges applied in the event of early termination of retirement annuity fund contributions. The Statement of Intent signed between the Minister of Finance and the life industry, as well as the subsequent *Discussion Paper on Contractual Savings in the Life Industry*, have identified the introduction of simple, standardised disclosure requirements as a key element of enabling comparability, more effective competition, improved governance and member protection.

132. A robust redress mechanism for most pension and provident fund members exists in the form of the Pension Funds Adjudicator. A clear case can be made for consistency and equality of treatment of fund members in terms of access to effective dispute resolution channels, which implies expanding the jurisdiction of the Office of the Pension Funds Adjudicator to include bargaining council funds not yet registered under the Pension Funds Act, public sector funds and certain parastatal funds. This in turn may require institutional reform of the Office. Fund trustees should also recognise that internal member dispute resolution mechanisms should be in place as a matter of good practice.

Funding rules

133. Though theoretically DC funds are fully funded by nature, adequately stringent funding requirements need to be in place for DB and hybrid schemes. Currently, South African funding rules compare reasonably with international standards. There is some room to build on this foundation, tightening up where necessary on a fund's liability to pensioners and the assumptions used in actuarial valuations.

Protection of benefits

134. Broadly speaking, member protection is a combination of adequate funding, the protection of rights to benefits (for instance on liquidation or transfer), good governance, adequate disclosure and trustee and member education. As discussed, minimum benefits have already been legislated. The process for the winding-up of a pension fund could be further clarified and strengthened.

135. Some commentators have argued for the introduction of a pension guarantee scheme. As international experience has shown, an assessment of the effectiveness and funding of such schemes is extremely complex, including considerations of moral hazard. Further investigation is required on the viability and suitability of such a scheme in the South African context.

Investment regulation

136. In defined contribution schemes, the pension fund member bears the risks of investment directly. In recent years, members of defined contribution funds have been encouraged to become more active in the management of their retirement fund investment choices and benefit structures. While this has the advantage of increased flexibility with respect to individual member needs and assets, it has increased the risks to members arising from limited investment expertise, poor advice, or fluctuations in the market. There is also evidence that members tend to make overly conservative investment choices given the number of years remaining to retirement.

137. It is not appropriate to leave members of the public, with varying levels of knowledge and experience of investment and finance, vulnerable to poor advice from service and product providers. Though laws such as the Financial Advisory and Intermediary Services Act seek to improve the standard of advice offered by financial services providers, it is also important that trustees play a rigorous role in safeguarding the interests of members.

138. Not only has this focused attention on trustee knowledge of investment principles, but also on the quantitative investment limits currently in place in the form of Regulation 28. While over time there is scope for larger funds to shift to a "prudent expert" approach to the investment process, it is expected that any future regime will continue to be a hybrid of prudent expert guidelines and quantitative limits.

139. Current quantitative limits have not been updated in some time, and further consideration, possibly involving a technical working group will need to focus on the following issues:

- Suitable quantitative limits for various asset classes, including derivative instruments;
- An appropriate definition of socially responsible investment (SRI) in the South African context and its interaction with existing initiatives such as the Financial Sector Charter;
- How SRI should be actively encouraged; and
- The scope for shareholder activism in South Africa and what duties this would specifically entail for the relevant stakeholders.

140. These are areas that invite broad consultation. Pension fund trustees and retirement fund industry participants themselves should be encouraged to develop tailored solutions to these challenges.

Effective supervision

141. In a recent comparison of the South African pensions system against OECD guidelines of pension governance and regulation undertaken by the National Treasury, one of the few areas in which the South African regulatory system required improvement was in the supervisory powers of the regulator. Currently, the Pension Funds Act provides the regulator with relatively weak enforcement powers. For instance, the Registrar first has to apply to court in order to intervene in the management of a fund (even when it is clear that a significant time delay would jeopardise the interests of members). These deficiencies are receiving attention through proposed amendments to the Act due to be heard in Parliament in 2007, bringing the Registrar’s supervisory powers in line with international practice.

3.7 Concluding note

142. Revised regulatory proposals, and ideas on supporting tax changes, will be published separately in March 2007. These proposals will be published with a view to eliciting comment and further debate that will contribute positively to the refinement of legislative and regulatory reform proposals during the course of 2007. In some cases, it will be necessary to establish technical working groups to further develop regulatory proposals.

143. The following approach is proposed subsequent to the release of these documents:

- Comments will be invited from all stakeholders;

- The comments will be reviewed for further discussion with stakeholders during the course of 2007, including consideration of the impact of evolving social security reform proposals;

- Where necessary, further technical work will be undertaken on the more complex areas of reform;

- The National Treasury proposals, stakeholder comments and the further analysis arising from any technical working groups will guide the work of a legislative drafting team in the preparation of a draft Retirement Funds Bill.

144. Through this consultative process, it is the intention to craft a strong, cost-effective, equitable and secure regulatory framework to ensure that the private pensions sector provides a sound supplementary pillar to the social assistance and contributory social security system.

Chapter 4: Tax Framework for Retirement Savings

4.1 Introduction and objectives

145. The proposed reforms to the structure and regulation of retirement saving aim to create an efficient and equitable framework for individuals to provide for their retirement. Mandatory contributions, compulsory preservation, portability and enhanced regulation together provide the foundation for the retirement funding reforms.

146. The tax treatment of retirement savings must complement these regulatory and institutional reforms in order to provide a consistent architecture within which individuals can make provision for their retirement. The reforms to the tax system seek to maintain sufficient incentive to provide adequately for retirement, while addressing inequities and complexity in the current system.

147. The assessment of the current tax regime and proposals for reform are guided by the following objectives:

- Encouraging sound long-term saving decisions;
- Providing incentives to save beyond the mandatory minima;
- Supporting decisions to favour long-term retirement saving over other forms of savings;
- Improving equity in the fiscal incentives for retirement saving;
- Supporting an efficient, competitive private pension funds sector;
- Minimising possible distortions to investment decisions by pension fund managers;
- Reinforcing tri-partite responsibility between individuals, employers and the state for ensuring sustainable retirement provision; and
- Managing the fiscal costs of retirement saving and provision.

4.2 Principles of retirement savings taxation

148. An international review of the taxation of retirement savings suggests that there is wide variation in the approaches adopted by different countries, reflecting their varying historical, social and economic circumstances.

149. However, most countries provide tax incentives for saving through retirement funds. Even when membership is compulsory, there remains a convincing case for providing incentives for retirement saving. Retirement saving is a long-term commitment and a responsibility that is shared between individuals, their employers and the state. A balanced framework of compulsion, regulation and incentives ensures that all parties contribute effectively to this long-term social contract. Moreover, international literature and evidence suggests that a combination of

compulsion and inducement is likely to be more powerful than either measure in isolation.

150. Typical reasons for fiscal encouragement for retirement saving, highlighted by the empirical and theoretical literature, include:

- Considerable evidence that individuals consistently save too little for retirement. Tax incentives, complemented by supporting institutional structures such as the mandatory minimum contributions, seek to remedy this.

- Retirement funds are normally more highly regulated and contain more conditions (such as compulsory preservation, mandatory contributions and restrictions on withdrawals) than other savings vehicles, in an attempt to ensure that members' savings are adequate and secure. The favourable tax treatment in this context serves to offset the adverse effects on returns and liquidity that would otherwise discourage savings in this medium.

- There are, particularly in emerging markets, important synergies between the development and maintenance of a robust pension environment and the development of financial markets, which have further economic development benefits.

- Relatedly, retirement saving institutions provide a stable long-term flow of funds, mainly directed to domestic investment, as funds seek to match long-term liabilities with the asset base.

151. A further argument for fiscal subsidisation is that the standard international benchmark for the tax treatment of retirement savings is the expenditure tax model.[6] The majority of countries internationally tend to tax retirement savings on a basis at least as favourable as an expenditure tax.[7] Under an expenditure tax model, the broad principle is that only those earnings that are available for expenditure (disposable income) are taxed. Funds that are saved are subject to deferred taxation – the savings and accumulated investment income and growth are taxed only upon withdrawal. On a theoretical basis, an expenditure tax introduces neutrality between consuming now and consuming in the future. In practice, evidence from international experience suggests that front-loaded tax benefits, through the favourable tax treatment of contributions, are significantly more effective in stimulating savings.

[6] This is often described as an "exempt-exempt-taxed" or "EET" model: contributions to retirement funds are exempt, in the sense of being eligible for full or partial deductibility, retirement fund investment income and growth is tax exempt and benefits are taxable.

[7] *Taxation: The tax treatment of funded pensions,* Whitehouse, E., World Bank, 2005.

4.3 Key reform challenges

152. The general objectives and principles highlighted above suggest a number of areas for potential reform of the current system of taxation of retirement saving. A more extensive assessment of the current system will be contained in a subsequent discussion paper, but some of the key challenges are highlighted below.

153. Viewed holistically, the current regime is complex for members and employers to comply with, as well as for the authorities to administer and regulate. Maintaining different rules for various funds, calculating the tax on retirement funds using different rules to normal income tax and computing taxes on benefits using various formulas all add to the complexity.

154. Equity in the system could be improved in a number of areas:

- The amounts individuals are allowed to save for retirement differ according to their employment relationship, with the self-employed generally being more restricted than other taxpayers in terms of the relief they receive;

- Higher-income individuals have greater fiscal incentives for retirement savings than low-income individuals because they benefit more from the tax deductibility of contributions and the tax-free lump sum; and

- Low-income individuals, by contrast, typically face a fiscal disincentive to save through retirement funds since such savings may be subject to tax while saving outside retirement funds is not, either because they earn below the tax threshold or because investment income falls below the interest and dividend exemption threshold.

4.4 Reform proposals for taxation on retirement saving

155. As outlined above, a review of international tax practice suggests that fiscal incentives for retirement saving in South Africa are appropriate to maintain and extend adequate income replacement in old age, over and above the basic retirement provision offered through social assistance and the proposed national social security fund.

156. Reforms to the tax system will seek to maintain sufficient incentives to provide adequately for retirement, while addressing inequities and complexity in the current system.

157. In keeping with practice in many other countries, proposed reforms will see a shift towards an expenditure tax treatment of retirement fund savings, including a uniform and more equitable tax treatment of contributions to pension, provident and retirement annuity funds, to be phased in over time.

Tax on contributions

158. In line with the intended standardisation of the regulatory framework for retirement funding, it is proposed that the tax treatment of contributions to the national social security fund, pension funds, provident funds and retirement annuity funds be consistent. Contributions to each will be aggregated to determine an individual's final tax position.

159. Detailed proposals on the tax treatment of retirement fund contributions will be developed during the course of 2007, but it is envisaged that the resultant tax environment will allow for:

- Tax encouragement of mandatory contributions to the national social security fund and private retirement funds;
- Limited tax-encouragement of a supplementary, voluntary component; and
- No special tax treatment above a certain ceiling.

160. The underlying rationale is that the returns on savings set aside to provide for a basic standard of living in retirement should not be diminished by tax. Above this basic standard, there should be some encouragement of further retirement saving to maintain an adequate standard of living; but above some level of present and future material comfort there is no longer any public purpose served by interference in the relative costs of alternative forms of saving and investment.

Mandatory contributions:

161. The proposed mandatory contributions to the national social security fund and private pension funds are aimed at providing a minimum standard of living in retirement for all South Africans. These mandatory contributions, up to a monetary cap, could be fully or partially deductible for income tax purposes. Mandatory contributions to the social security fund by lower income workers would be supported by the proposed wage subsidy. These are issues that require further investigation in parallel with work on social security reform.

Additional voluntary contributions:

162. Some fiscal incentive is also envisaged to further promote retirement saving above the basic minimum provided for through mandatory contributions. These incentives will provide a unified tax regime for contributions to occupational pension and provident funds, as well as individual retirement funds, so as to remove the current inconsistencies in treatment.

163. A number of alternative permutations exist for the taxation of contributions to retirement funds, including full or partial tax deductibility at marginal personal income tax rates, or a tax credit system, which is roughly equivalent to allowing a tax deduction at a standard rate.

164. Further work needs to be undertaken to both analyse and cost the impact of various options.

165. However, a key element of improved equity in the tax treatment of retirement savings is that a tax deduction or tax credit would be capped in some way. Tax incentives based on a simple deduction of retirement fund contributions from income tax liability tend to be regressive because higher income individuals receive a higher tax benefit than lower-income individuals.[8] Tax incentives are generally capped by applying them only to contributions that fall within a certain percentage of gross income or a fixed monetary cap, whichever is the lower.

166. Key issues for consideration during the course of 2007 would include the allowable contribution rate and the monetary caps on allowed contributions.

167. A particular issue that requires attention is the need for the system to accommodate individuals with volatile incomes, periods of unemployment or who simply defer membership of a retirement fund until later in life.

Abolition of retirement fund tax

168. Consistent with the shift toward an expenditure tax model for the tax treatment of retirement savings, the tax on retirement funds will be abolished with effect from 1 March 2007.

169. This reform will make an important contribution to enhancing the adequacy of funds available in retirement through removing the compounding effect of annual taxation on the investment income accruing to funds, whilst simplifying the tax treatment of retirement savings. Furthermore, it moves toward a more tax-neutral environment in which fund managers make decisions regarding the allocation of funds based to a lesser degree on tax considerations.

Tax treatment of benefits

170. Many countries around the world have a partial exemption for the taxation of retirement benefits or special features that provides further relief from income tax for

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[8] In principle, an expenditure tax approach means that individuals receive a tax-free rate of return on their retirement saving regardless of their tax bracket, implying that the greatest benefit goes to those facing the highest tax rates. Moreover, in practice, most taxpayers face a lower tax rate in retirement (when benefits are received) than during their working life (when tax-deductible contributions are made), meaning that retirement savings by higher income individuals may be unfairly subsidised.

retirees. South Africa is no exception, with a tax-free lump sum receivable from retirement funds, a secondary rebate and additional tax deductions for medical costs.

171. The aim of regulation in this area is to encourage individuals to take their retirement benefits as an annuity. Consistent with current practice, the regulatory proposals recognise however that upon retirement there are sometimes particular circumstances where part of the retirement benefit is needed as a lump sum, such as to pay off mortgages.

172. It is proposed that the current situation whereby individuals can receive a limited tax-free lump sum retirement benefit be retained. However, the current tax treatment of lump sum benefits upon retirement is overly complex. It is proposed that the tax rules for lump sum benefits be simplified considerably. To streamline the tax administration process, withholding taxes on lump sum benefits to persons with taxable income of less than R43,000 per year (the revised income tax threshold) will be abolished.

4.5 Concluding note

173. Further details of potential tax reform principles will be published in the coming months. It is hoped that a complete package of reforms will be finalised during the course of 2007, following further consultation in the light of social security reform proposals.

Conclusion

174. This discussion paper sets out the main proposals for a broad-based contributory social security system and improvements to the South African retirement fund industry.

175. Against the background of a growing economy, accelerating employment creation and a budget surplus for the first time in several decades, the time is right for bold new steps in improving income security of the poor and strengthening the fabric of social solidarity that binds all South Africans together.

176. Income insecurity in old age, and the vulnerability of families to death or disability or unemployment of a breadwinner, are challenges faced by all, rich and poor. South Africa has a well-established occupational and individual retirement funding industry that provides protection to many, and a substantial social assistance grant programme that provides income support to the poor. But between the means-tested grant programmes and tax incentivised saving, there is effectively no fiscal support for saving and social insurance; the basic, contributory, earnings-related social protection system is incomplete and uncoordinated.

177. These proposals aim to address this disjuncture. The redistributive social assistance minimum benefits floor will remain in place, funded through the budget. A basic social security arrangement is proposed to complement this, as a mandatory, pooled, contributory, administratively simple social protection system. A wage subsidy will be introduced to offset the costs to low-wage earners of the social security contribution and to encourage employment creation. Above an agreed threshold, retirement savings will continue to be mandatory, but will mainly be provided by occupational and individual schemes within a regulated industry. Voluntary retirement savings will continue to be tax-encouraged; but, above a certain percentage of earnings or monetary cap, the tax incentive will fall away and savings and investment decisions will be driven less by tax considerations.

178. The wider social security framework is not just about protection against income vulnerability, but it includes compensation for occupational injury and disease, road accident benefits and health insurance arrangements. These go beyond the scope of this discussion paper, but it is recognised that progress towards a basic contributory income protection system may provide a platform on which other reforms can be built. For the period ahead, however, there is a great deal of further work to do in developing the details of the proposed social security system and associated retirement industry reforms.

179. It is in a spirit of engagement with all interested parties and stakeholders that these proposals are put forward. The broad division of roles and responsibilities is clear: the state will continue to provide basic social assistance through the grants system; all South Africans will share in a basic contributory social security system; the

private retirement fund sector will continue to provide supplementary retirement funding and risk benefits in a regulated, competitive industry.

180. Many transitional arrangements and sufficient institutional support will be required, with special attention to be given to the co-ordination of the introduction of a wage subsidy with the requirement to contribute to social security. These are reforms that will take several phases to be fully implemented. Their contribution to poverty reduction and income security will take time, their impact reinforced and magnified from one generation to the next. These are investments in social cohesion that will be felt long into the future, and we owe it therefore to our children to be vigorous and critical in our debate.