NATIONAL TREASURY
REPUBLIC OF SOUTH AFRICA

RETIREMENT FUND REFORM

a discussion paper

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CONTENTS

PRINCIPLES OF RETIREMENT REFORM

Objectives of retirement funding policy

The organisation and financing of income security in retirement is amongst the most profound 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 principles of solidarity, risk-sharing and prudential foresight.

The South African retirement fund industry has been heavily influenced by a racially divided past and the parallel existence of developed and emerging components of our economy. There is a large and well-established private contractual savings sector, government employees are provided for through a near-fully funded retirement arrangement, but approximately three-quarters of the population reach retirement age without a funded pension benefit and hence rely on a government social assistance grant programme.

Though there are features of the structure and depth of the South African retirement funding environment that compare well with both developed and developing countries, there are also decidedly unsatisfactory aspects. Government seeks to build on the strengths of the established retirement funding environment, while progressively addressing its deficiencies.

The broad objectives of retirement policy can be simply stated. Government seeks to:

- Encourage individuals to provide adequately for their own retirement and the needs of their dependants.
- Encourage employers and employees to provide for retirement funding as part of the remuneration contract.
- Ensure that retirement funding arrangements are cost-efficient, prudently managed, transparent and fair.
- Promote the retention of purchasing power of pensions through protection against the effects of inflation, within the resource constraints of the fund.
- Improve standards of fund governance, including trustee knowledge and conduct, protection of members' interest, accountability, and disclosure of material information to members and contributors.
- Provide, through social assistance, an assured basic income entitlement to elderly persons without means.

In developing proposals for further pursuing these objectives, it is necessary to give careful attention to aspects of the retirement funding environment that may significantly shape or influence reform options. Several general considerations are briefly outlined below. These – and the more detailed discussion of reform proposals in the annexures to this discussion paper – are published with a view to eliciting comment and debate that contribute positively to the refinement of legislative and regulatory reforms proposals during the course of 2005.

Modernisation and reform – the South African retirement funding landscape

The retirement funding system has been in place for a long time, and has an established body of legislation governing it, principally codified in the Pension Funds Act, promulgated in 1956.

Over the course of the past 48 years there have been numerous amendments to the Act, updating it where considered necessary in an *ad hoc* fashion, introducing features such as member-elected trustees, the Pension Funds Adjudicator, minimum benefits and surplus apportionment. Therein however lies one of the reasons for a review of the current legislation: it needs careful review to ensure consistency and to resolve problems introduced by the piecemeal addition of a variety of measures. A review of the Act should aim at consolidating and integrating retirement funding arrangements, while also contributing to a more consistent and coherent structure and regulation of the broader social security system in South Africa.

Not only have there been a plethora of amendments to the Act, but a number of South African commissions have investigated the intricacies of retirement funding and provided their assessment. They include, with varying emphases: the Mouton Commission (1992), Katz Commission (1995), Smith Commission (1995), National Retirement Consultative Forum (1997), and the Taylor Committee (2002). The recommendations of these committees and commissions have been taken into account in formulating this policy document, and contain further advice that may find expression in the more detailed legislative and regulatory reforms that will follow the present consultation phase.

Annexure 1 – which describes in broad outline the South African retirement funding landscape – sets out the essential case for modernisation and reform of the Pension Funds Act. Although our retirement fund system is in many respects financially sound and well regulated, too many people reach retirement age without adequate accumulated savings. For too many people, the build-up of savings is disrupted or the costs associated with retirement fund provisioning are unacceptably high. Between the basic old age social grant, on the one hand, and private contractual and voluntary savings vehicles on the other, there is a notable lack of cost-efficient vehicles appropriate to meeting the retirement funding needs of lower and middle income people, and those whose lifetime earnings are largely informal or irregular.

Access, compulsion, and preservation

The degree and form of compulsion in the retirement funding system, the alternative vehicles available for contractual savings, the balance between preservation of retirement benefits and availability of savings for other pressing needs, and the differentiation in the tax and regulatory treatment of alternative categories of savings, are key determinants of the trajectory, over time, of the proportion of people with access to retirement fund income and the adequacy of these pensions.

These issues are addressed in Annexure 2.

Though there is wide coverage in South Africa of those in employment, by international comparison, many people lack effective access to an affordable retirement funding vehicle. This relates to the structure of the economy – South Africa has a high rate of unemployment, a large informal sector, and many working-age individuals who have periods of unemployment scattered throughout their working lives. These features have to be taken into account in considering retirement funding reform options. But the retirement and social security funding environment also influences the evolution of the economy: the rate and form of savings, costs and benefits of employment, and inter-dependency amongst households.

National Treasury considers it crucial to improve the access of those whose employment income is modest or irregular to cost-effective retirement savings mechanisms. This is achieved in some countries through mandatory social security contributions – effectively, part of the tax structure – earmarked for some mix of retirement, disability, unemployment and sometimes health care benefits. Pooled social security funds, managed on a pay-as-you-go basis, can finance basic benefits for those whose lifetime contributions are inadequate, subject to the extent of redistribution that can be sustained without fiscal distress or social discontent. However, social security taxes raise employment costs and pay-as-you-go arrangements carry inherent fiscal and financial risks. Over the past two decades a number of countries have opted rather for mandatory privately managed retirement funds, adapted in varying ways to accommodate the self-employed or those with irregular incomes.

South Africa has a long-established social grants system, financed directly through the fiscus. Separate social security funds are in place to finance unemployment benefits (and maternity leave), compensation for occupational injuries 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. The intended consolidation of social grants administration in a single, national Social Security Agency – with responsibility for managing monthly payments to over 3 million old age pensioners and over 6 million other grant beneficiaries – invites consideration of the possible extension of the social grants system to include a basic contributory pension supplement arrangement. It has long been recognised that the means test that currently applies to the old age grant suffers from both design and implementation defects, and its reform needs to be considered alongside options for complementary contributory arrangements.

There are other candidates for improving access to retirement saving opportunities. Annexure 2 proposes that a new Act should establish a special fund to be known as the National Savings Fund, which will permit, *inter alia*, irregular contributions. Public comment is invited on the details of this proposal.

Benefits, contribution rates and member protection

Pension funds over the last 48 years have developed tremendously. Worldwide, there has been a shift from defined benefit funds to defined contribution funds. In the former, the employer bears the risk of worse than expected investment returns or higher than expected expenses. In the latter, these risks, and the corresponding benefit of favourable returns, are effectively transferred to the individual fund member.

Over 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 contributed to greater depth and competition in the industry, it has increased the risks to members arising from limited investment expertise, poor advice, or the vagaries of the market.

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, and possibly exploitation by, service and product providers. Initiatives to improve education and governance in this regard are important and are strongly encouraged by Government. The proposed new Act will also provide channels for improved member and trustee education.

Annexure 3 describes reform proposals relating to various aspects of the contribution and benefits structure of retirement funds and protection of members' interests. These include:

- Inflation-related pension adjustments
- The range of benefits which may be financed through retirement funds
- Payment of benefits through a lump-sum or a flow of income
- Post retirement medical funding
- Minimum benefits
- Preservation of benefits and portability in the event of unemployment or changes in employment
- Interest on late payment of benefits
- Unclaimed benefits
- Access to retirement savings for housing loans and guarantees
- Access to retirement savings for life crisis needs
- Permissible deductions from retirement fund benefits
- Division and protection of benefits on divorce
- Payment of benefits on death or disability.

The exact total amount of unclaimed retirement benefits across all retirement funds is not known with certainty, but the magnitude is large enough to warrant serious consideration as to what must be done about these benefits. Ultimately, if left unclaimed, such benefits revert to the fund in question and become part of the "surplus" of the fund. In the case of the death of a member, dependants and/or relatives that cannot be traced are denied money, which is rightfully theirs. The new Act must provide for the identification, tracing and payment of unclaimed benefits to these former members and their dependants.

Fund Governance and Regulation

Inextricably linked to member protection is the character and structure of fund governance, and the design and reach of the regulatory regime. Pension fund failures do not occur often, but when they do, the consequences can be disastrous, especially for members who have spent their entire lives contributing, only to find their benefit compromised. A severe loss in fund asset value may arise from many causes – poor investment performance, defective fund management, or even fraud. In almost all cases, however, there is an underlying failure to exercise appropriate and sufficiently rigorous standards of fund governance.

These issues are reviewed in some detail in Annexure 4.

Specific proposals are set out for reform of the Pension Funds Act in respect of:

- Powers of the Regulator
- Statistical reporting by funds
- Member protection
- Establishment of a specialist tribunal to adjudicate retirement funding disputes
- Duties and standards relating to the conduct of fund trustees
- Resolution of uncertainties relating to the intersection of labour law and the governance of retirement funds
- Principles and regulations related to investment management and members' investment choice
- Funding and actuarial calculation
- Winding up of a retirement fund.

The powers of the Regulator in terms of the current Act are limited. Supervisory and enforcement powers need to be bolstered to ensure effective implementation and administration of the new Act. Currently, for instance, the Regulator cannot remove a trustee from his/her position of office, nor can the Regulator sanction a service or product provider. This cannot be optimal, if it is found, for instance, that a trustee, service or product provider has failed in his/her fiduciary duty to the fund. The Regulator should have the power to fine, remove or disqualify the person from continued work with that fund and/or all other funds.

A further example is the case where a fund does not submit its annual financial statements to the Registrar on time. In this case, it is the fund itself (not the management board, or administrators of the fund) which is fined 50 rand a day for non-submission. Such a rule merely penalises fund members by reducing their benefits, and does not promote a culture of compliance.

Recognising that members need to be adequately represented when it comes to the management of their funds, the current Act requires that members of funds regulated by the Act be given the right to elect at least 50% of a fund's board of management, with the employer appointing the balance of the board. The exception to this is, for instance, in multi-employer or "umbrella" funds, where in the past, such a provision has been seen as impractical. In such funds, the sponsor (frequently the administrator) generally appoints the trustees. The new Act must give special attention to umbrella funds and the accompanying difficulties attached to the management of those funds.

Recent legislation, such as the Financial Advisory and Intermediary Services Act, Financial Services Ombud Schemes Bill, and Financial Intelligence Centre Act, have as their primary focus the protection of the consumer and the provision of efficient channels for dispute resolution. In the new Act, it is considered prudent that more specific provisions governing the conduct of trustees and service and product providers, in relation to retirement funds, be included in the statute which will give added substance to principles embedded in recent legislation. This will include limitations on where funds may invest, unless so otherwise approved by the Registrar. In essence, such a subsection will be a revision of the current Regulation 28, which is outdated – for example in its failure to deal with the use of derivative instruments – and can be creatively circumvented.

In terms of the Labour Relations Act, employers and employees (or trade unions representing employees) may negotiate the employment contract, in which provision may be made for retirement funding. Clarity is required in order to distinguish what employee benefits must be determined or changed under the Labour Relations Act through collective bargaining, and to what degree the provisions of the new Retirement Funds Act will have applicability to such a bargained agreement. It is important that statute provide appropriate protection to members without inadvertently increasing the cost of doing business.

Conclusion

There are many reasons, some canvassed above, for reviewing the existing Act, seeking improvements in the structure and evolution of the South African retirement funding system, and adapting associated regulatory requirements and tax measures. National Treasury is persuaded that, for the reasons outlined here, a substantial review and updating of the current Act is warranted. Against the background of the numerous commissions and committees in South Africa that have considered the matter of retirement funding, their various recommendations, and a consideration of international standards of pension funds practice, this discussion document puts forward the broad principles set out above and the specific proposals detailed in the accompanying annexures, for further consideration.

Absent from the detailed proposals accompanying this discussion document is any consideration of the tax treatment of retirement funds. This important aspect of the retirement reform project needs to be dealt with in the context of a broader framework of objectives and institutional reforms, and will be the subject of a separate discussion paper.

Annexure 1

THE SOUTH AFRICAN RETIREMENT FUNDS LANDSCAPE

1. Introduction

In the 1970's, most retirement funds in South Africa and in fact worldwide were defined benefit funds, managed by employer-appointed boards of management. Benefit design favoured retirement and death but penalised resignation: a member's own contributions were refunded with a rate of interest lower than rates available on discretionary savings, and an increase (representing a share of employer contributions) was only included after a long period of service, in order to encourage employees to commit to their employer for the long-term.

The 1980's and 1990's saw a dramatic transfer of employees from these defined benefit funds to defined contribution schemes. This was viewed positively by trade unions, which saw advantages for their members in the better resignation benefits offered by newly established national provident funds[1], and by white-collar employees who sought to capture the investment rewards of a bull market. Employers preferred a defined contribution arrangement, since it provided for the capping of their personnel expenses, eased the introduction of package remuneration approaches, and it transferred the investment and expense risks to the employee[2]. In most cases the old defined benefit fund was closed to new employees.

Today, the vast majority of employees in the private sector belong to defined contribution schemes, while public sector funds are still largely defined benefit arrangements.

The South African environment has also seen considerable growth of multi-employer or "umbrella" funds. Such funds offer ease of access, especially for the employer, usually have lower unit costs than stand-alone retirement funds, which are to the advantage of the member, and frequently offer improved communication and administration facilities. Most of the large trade unions have established national defined contribution funds and have negotiated an option for their members to belong to such funds, as opposed to membership of an employer-sponsored fund.

After the initial transfer of most of their in-service members to defined contribution funds, some defined benefit funds shrunk in membership to the extent that they were no longer financially viable. Collapsing them into the new defined contribution funds, but preserving features of the defined benefits that the members enjoyed, has given rise to hybrid arrangements, which therefore have features of both defined benefit and defined contribution funding.

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[1] In a provident fund, the full benefit on retirement is a cash lump sum as opposed to a pension.

[2] In a defined contribution fund, the member's retirement benefit is secured by the accumulation of contributions, fixed as a percentage of remuneration, less expenses, at the nett investment return earned by the fund. Where the contribution rates by members and employer are fixed in total, the members bear any increase in expenses such as rising insurance premiums as a result of HIV/AIDS. Members' benefits are directly impacted by any investment gains or losses.

Consequently today the South African retirement funding system hosts a variety of funds, from defined benefit and defined contribution, to hybrid funds, and multi-employer funds. It is suggested that the new Act acknowledge the intricacies of each type of fund, but provide an equitable structure under which all funds must operate.

2.1 The "Three Pillars" of a Retirement Funding System

It is helpful, and in keeping with a framework proposed by the World Bank, to distinguish three separate "pillars" of a retirement funding system:

- The first pillar is a public benefit programme, funded from general government revenue, which is aimed at redistribution (from the more well-off to the poor) in order to prevent poverty in old age.

- The second pillar is typically privately managed, fully or partially funded, with mandatory participation, within which individuals save to provide themselves with an income during retirement.

- The third pillar comprises voluntary savings, permitting individuals to choose how they allocate income over their lifetime.

Applied to the South African context, the following broad categories can be distinguished.

Pillar 1 comprises the social old age grant. It is the main source of income of over 75 per cent of women over the age of 60 and men over the age of 65, including many people with many years of formal or informal employment behind them.[3] The old age grant is a means-tested payment of R740 per month (as at November 2004), administered mainly by payments contractors on behalf of provincial Departments of Social Development. The means test lowers the benefit by 50 cents for every R1 of other income, to a level of zero when other income exceeds R1480 per month. In practice, the test is not effectively administered, creates a disincentive for low-income earners to save for retirement, and contributes to a widespread preference for provident funds that pay lump-sum rather than annuity benefits.[4]

Under pillar 2 are the various pension and provident fund arrangements associated with formal sector employment, in either the private or public sectors. Individuals under pillar 2 may have periods of interrupted employment, though not for an extended period of time.

Pillar 3 represents voluntary saving. In South Africa, the self-employed may not participate in occupational retirement funds and are compelled to use the same vehicle as others use to supplement pillar 2 provision. Under pillar 3, therefore, are included

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[3] There is concern that the qualifying age differentiation between women and men may be subject to constitutional challenge, although National Treasury notes that there is a strong defence against such challenge in the significant difference between labour market and lifetime earnings prospects of men and women.

[4] Approximately 12% of total national and provincial government expenditure is allocated to social grants, including old age, disability, child support and other social security payments.

contractors, consultants and other professional people, who undertake retirement funding for themselves, and individuals who supplement any provision made through occupational savings vehicles.

It is estimated that approximately 50% of the economically active population provide for their retirement through occupational and voluntary saving arrangements, although a proportion of these will nonetheless fall back on the social old age grant as well.

A substantial proportion of the South African economically active population derive incomes from informal, irregular or unregulated economic activities. The degree to which they save for their retirement is difficult to measure. The access they have to adequate retirement funding vehicles is limited by relatively high administration costs and constraints such as a requirement for minimum regular contributions. For these people the pillar 1 old age grant is a valuable safety net, but they may also during their working years contribute to pillar 2 or pillar 3 savings vehicles. They represent at least 20% of the economically active population. Providing improved access to an affordable retirement saving vehicle for those with irregular and informal earnings is a key reform objective. The concept of a National Savings Fund – articulated in Annexure 2 – is designed to address this.

Comparison with international regulatory principles advocated by the International Network of Pension Regulators and Supervisors demonstrates that the South African regulatory system satisfies international standards. Government intervention in the investment affairs of pension funds is limited to quantitative maxima that attempt to ensure a prudent mix of investments.

In broad terms, the South African retirement system conforms with the model advocated by the World Bank: there is separation of poverty relief, in the form of the Social Old Age Pension or "SOAP", under pillar 1, from retirement savings through occupational retirement funds (pillar 2), and retirement annuity funds, collective investment schemes and insurance policies (pillar 3), serviced by a sophisticated financial services industry, regulated to international standards.

2.2 Employment and Coverage

According to the 2001 Labour Force Survey, it is estimated that employment is split along the following lines:

	(000s)
Formal sector	7539
Informal sector	2232
Domestic Service	916
Unspecified	146
Total	**10833**

The average number of members reflected in the Registrar of Pension Funds' Annual Reports for 2000 and 2001 is 7,64 million, of whom 2,6 million were members of retirement annuity funds. As retirement funds only effectively reach employees in the formal sector, this suggests more than 100% coverage.

However, these two sets of figures are not directly comparable since some people belong to more than one fund, and are thus double counted in the Registrar's figures. Making assumptions as to the proportion of employees likely to belong to more than one fund, it has been estimated that coverage for employees in the formal sector is between 66% and 84%. Even at the lower end of this range, this can be considered a good coverage ratio, comparable even to countries with mandatory systems.[5]

It must be stressed that although coverage is seemingly relatively high in the formal sector, the challenge of extending coverage to those who are not in full-time employment in the formal sector remains.

2.3 **Contribution Rates and Costs**

The World Bank advocates contribution rates of between 10% and 13% of total annual salary as a suitable level for the second pillar.

The Sanlam Survey reported the following average contribution rates for defined contribution funds:

	2004 survey[6] (% payroll)		2002 survey (% payroll)	
Employer contribution		10,2		10,6
Insurance premiums:				
Death	2,5		1,9	
Disability	1,8		1,5	
Administration fees[7]	1,4	5,7	1,0	4,4
Savings component of the employer contribution		4,5		6,2
Member contribution		6,3		6,2
Total contribution saved for retirement		**10,8**		**12,4**

Contribution rates for defined benefit funds were, on average, higher than the rates for defined contribution funds.

South Africa, in terms of contribution rates, for those who are formally employed, therefore compares favourably with the range advocated by the World Bank.

The above cost considerations imply that it is reasonable to assume a **10%** payroll contribution towards retirement funding after expenses, when determining replacement rates for the system as it is currently, although the increase in insurance premiums and administration fees is a worrying trend that will require attention. Retirement fund members must have both direct and indirect costs disclosed to them and have a clear illustration of how much of their total retirement fund contribution effectively goes

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[5] Chile, which has a mandatory system, has a coverage ratio of approximately 62%.
[6] It has been argued that as the number of participants in the 2004 survey was relatively low, the results do not adequately reflect the state of the industry.
[7] These exclude the costs of investment management on a bulk basis for the fund, amounting on average to approximately 0,6% of the assets per annum, but include the cost to maintain individual accounts for the members.

towards paying various costs, including the cost of the provision of risk benefits. Furthermore, commissions and fees paid to service providers should be fully justified to the board of management of a fund, and should not be disproportionate to the value of the service or product provided.

2.4 Replacement Rates

The replacement rate is essentially the percentage of final salary that will be paid to the member after retirement. It has been calculated that[8], given *inter alia* the assumption that 10% of payroll after expenses and risk benefits goes to retirement, the following replacement rates will be achieved, for real investment returns of 2%, 3% and 4%:

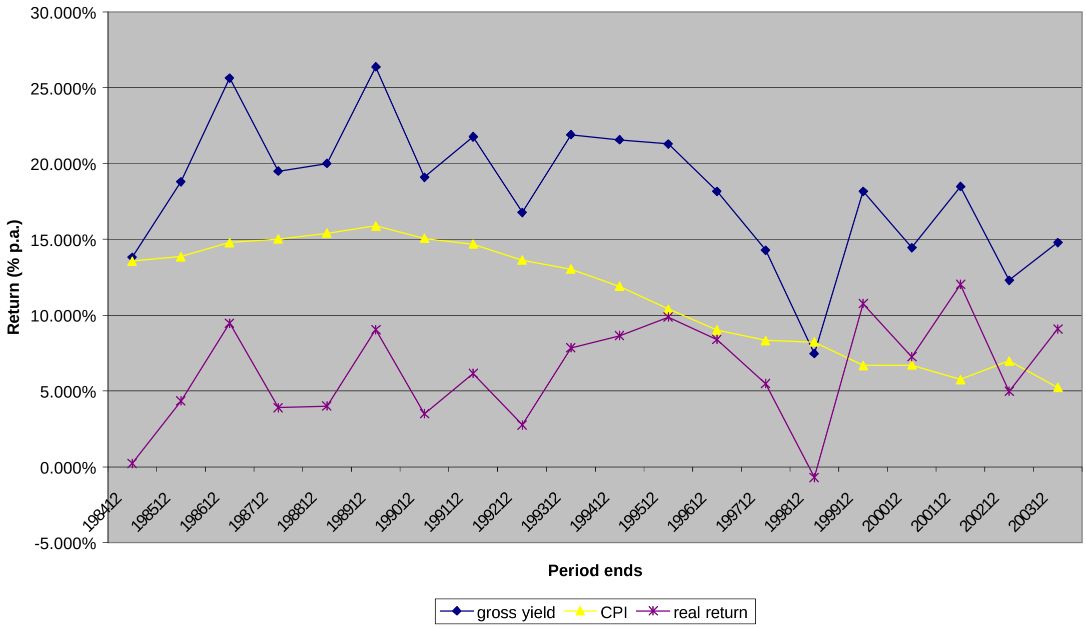
Years of contribution before retirement	2% real return	3% real return	4% real return
10	8.2%	8.6%	9.0%
15	13.0%	13.9%	15.0%
20	18.1%	20.0%	22.1%
25	23.8%	26.9%	30.6%
30	30.0%	34.9%	40.8%
35	36.8%	44.1%	53.0%
40	44.3%	54.5%	67.7%
45	52.5%	66.6%	85.3%

The above table clearly highlights the benefits of:
(a) contributing for a long time towards retirement and;
(b) staying invested,
in other words, severe leakages from retirement savings make it extremely difficult to obtain a high replacement ratio upon retirement.

The graph below illustrates real returns on regular amounts invested, gross of Retirement Fund Tax ("RFT") and investment management fees. Some allowance is likely to be needed, also, for salary increases slightly in excess of price inflation. Deducting estimates of the likely costs at current levels (0,6% for RFT, 0,6% for investment management fees, and 1% for salary increases in excess of price inflation) suggests that a rate of 3% real is reasonable if the trend stabilises at current levels.

[8] This assumes that conversion from accumulation into income takes place at a rate of R13,8 of capital buys R1 of pension at age 65. Under current market conditions this should enable funds to pay increases equal to the rate of change in the Consumer Price Index.

Graph 4: Real return earned
(regular investment for 5 year periods ending on 31 December - quarterly investment during 1980's, monthly thereafter)



Assuming a retirement funding contribution of 10% of salary, net of expenses, over the whole of an employee's working life, and assuming real rates of investment return of 3%, the replacement rate from the average defined contribution retirement fund, will be slightly in excess of the 40% to 50% level found in the Pillar 2 systems in OECD countries.

If the contribution rate changes, the replacement ratio changes proportionately. So, for example, assuming a 3% real return, the replacement ratios from different contribution rates, after deducting expenses, are as follows:

Years of contribution before retirement	Replacement ratio contribution rates of		
	8%	10%	12%
10	6.9%	8.6%	10.4%
15	11.1%	13.9%	16.7%
20	16.0%	20.0%	24.0%
25	21.5%	26.9%	32.3%
30	27.9%	34.9%	41.9%
35	35.2%	44.1%	52.9%
40	43.6%	54.5%	65.4%
45	53.3%	66.6%	79.9%

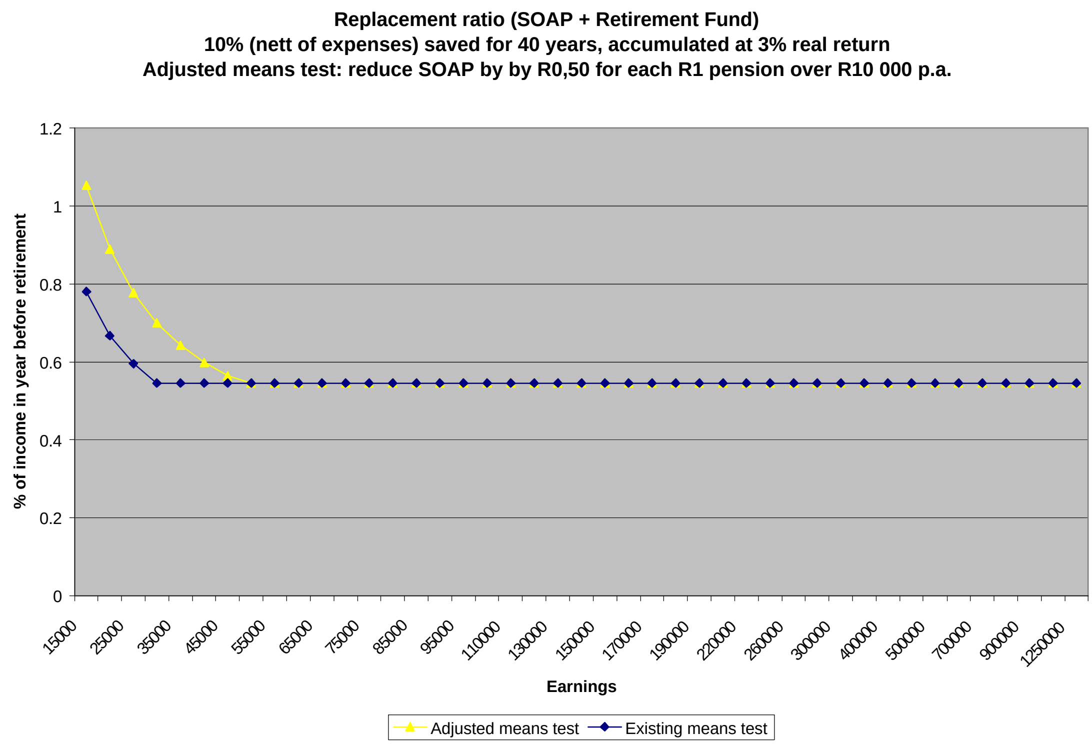
2.5. **Leakage**

One major reason people are retiring from the formal sector with insufficient retirement benefits (in terms of international comparisons) is leakage from the system: resignation benefits have been poorer than the amount accumulated on behalf of the member, employees have not re-invested their retirement savings on a change of jobs, and many have used them to fund periods of unemployment.

The introduction of compulsory minimum benefits in the Pension Funds Second Amendment Act, 2001, should prevent the first cause of leakage. The other causes must still be addressed.

2.6. **Interaction with the Social Old Age Pension**

The replacement ratio for lower income earners can be changed significantly by altering the means test for the social old age pension ("SOAP"). Currently the means test deducts R0,50 of the SOAP for each R1 of pension, starting from the first R1 of pension, and when the individual's deemed income reaches R17 760 per annum, the SOAP reduces to zero. If the threshold for the SOAP deduction is increased to, say, R10 000 per annum, the SOAP will be paid in full if income is below R10 000 per annum and will drop to zero after an income of R27 760 per annum. The replacement ratios from the combination of SOAP and retirement fund benefit, on both bases, is illustrated in the following graph which assumes a contribution of 10% of salary is saved, after deducting all expenses, for a period of 40 years prior to retirement, and a real return of 3% is earned:



2.7. **Summary**

Coverage in the formal sector is relatively good, even when compared to international levels. The retirement funding system itself may be considered sound and funds which are supervised by the Registrar of Pension Funds are generally regulated to international standards, but the challenge remains to provide an adequate vehicle for retirement for those in the informal sector and/or those only able to make irregular contributions.

Leakage from the system is significant, and this has a negative impact on the replacement ratio at retirement. The costs of administration and insurance premiums are a major concern and will need to be kept in check, as cumulatively over time, these can have a large impact on the benefit the member is to receive on retirement. As part of a holistic review of retirement funding in South Africa, the relationship between the means test and the social old age pension, should be reviewed.

Annexure 2

ACCESS, COMPULSION, AND PRESERVATION

1. Compulsion

1.1. Currently, in South Africa, an employer may decide whether to participate in a retirement funding arrangement, or not, and what categories of employee are eligible to join the fund. If the employer participates in respect of any category of employee, future new entrants to that category must join the retirement fund. Eligibility criteria, contribution rates and benefit structures are determined initially by the employer or the trade union that establishes the fund, but can be amended thereafter by the management board of the fund. In unionised environments, such amendment usually occurs after negotiation between employer and employees, or trade unions acting on behalf of employees. Without compulsion, a private retirement fund system has flourished. As indicated in Annexure 1, South Africa has levels of participation in the formal sector and contribution rates that compare favourably[9,10] with mandatory systems.

1.2. Compulsory membership of retirement funds and compulsory levels of contribution by employees towards retirement savings, are commonly found in countries where the governments are trying to shift the burden of retirement provision from public schemes funded from current revenue to private schemes which are fully funded[11]. In developed economies, Latin America and many parts of Asia, reform of the publicly funded social security benefits is required because they offer high pensions in relation to incomes earned prior to retirement and the proportion of people who are working relative to people who are retired is falling. If there is not reform in such systems, the tax burden on the working population will become very onerous if the social security benefit is to continue to be funded. In the face of a pressing need for reform, such jurisdictions introduce compulsory membership of private funds and compulsory rates of contribution. As the private schemes develop, governments in those jurisdictions anticipate that the publicly funded social security benefits will be reduced.

1.3. South Africa has no pressing need for such structural reform because –

1.3.1. The social old age pension is sustainable and is set at a level, which is modest in relation to earnings in the formal sector. The

[9] For example, Chile, the pioneer of public sector pension reform, introduced compulsory private funded schemes in 1981. Recent research demonstrates coverage of 61% of workers surveyed in a major urban area in Chile. Participation levels in South Africa in the formal sector are estimated as between 66% and 84% (see chapter 2).

[10] Chapter 2 shows an average contribution rate to defined contribution funds which is higher than the World Bank model, and compares favourably, for example, to the legislated minimum of 9% of pensionable earnings in Australia.

[11] This applies to nearly all the countries in Central and South America and Eastern Europe.

way in which the social old age pension is applied and administered, however, may need review (eg. modifying the means test);

1.3.2. South Africa does not have a population which is ageing to the extent found in most developed economies, Latin America and Asia[12];

1.4. While the *Mouton* and *Smith Reports*, and the *National Retirement Consultative Forum*, were concerned that compulsory retirement provision would not achieve appreciable savings in the cost of providing old age assistance because of current and future expected high levels of unemployment and underemployment, the *Taylor Report* recommended compulsory minimum contributions towards retirement funding. All commissions advocated encouraging the extension of occupational retirement provision to everyone in formal employment. However, one of the problems of mandatory systems identified in countries such as Chile is that they may encourage people and businesses to remain in the informal sector because of the perceived costs associated with moving to the formal sector. The *National Consultative Retirement Forum* attributed the failure to extend coverage to all employees in the formal sector largely to categories of employee such as part-time employees, contractors or seasonal workers, where either the employees themselves chose not to join a fund or they were ineligible to join. Countries such as the Republic of Ireland are attempting to address these problems by requiring employers to offer access to retirement funding to all employees, either on a group or an individual basis, together with education on the desirability of saving for retirement.

1.5. In the circumstances there is no need to compel every employee to belong to a retirement fund, or to pay particular rates of contribution, by legislation.

1.6. The National Treasury Task Team accordingly recommends that:

1.6.1. Participation be encouraged by the following measures:

1.6.1.1. The determination of the particular fund to which a category of employees would belong, and the benefits, contribution rates, and determination of pensionable remuneration applicable in that fund, would form part of the conditions of employment to

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[12] In 2010 the projected numbers of people aged 65 and over per 1000 people between the ages of 15 and 64 were between 250 and 350 for the UK, France, Germany, Italy, Spain and Japan. These are projected to rise by approximately 100 lives by 2030. Japan's expected rise is relatively the highest, from approximately 250 (2010) to almost 450 (2030). The USA and Russia have figures of 180 to 200 (2010) rising to between 300 and 350 (2030) respectively. Statistics South Africa estimate from Census 2001, that there are 28,2 million people aged between 15 and 64 compared to 2,2 million aged 65 and over, giving a ratio of 78 people aged 65 and over per 1000 people between the ages of 15 and 64. The number of people under the age of 14 is significantly larger than the group aged 45 to 64, suggesting that the ratio will not deteriorate over the next 20 years.

be negotiated between employer and employees (or trade unions representing the employees);

1.6.1.2. If an employee is not required to belong to a particular retirement fund as a condition of employment, the employer will be required to offer each new employee:

(a) education on the desirability of retirement savings and information on his or her retirement savings options; and

(b) payroll facilities so that the employee may join an individual retirement fund (defined as a retirement fund membership of which does not depend upon an employer / employee relationship), or the National Savings Fund (see below), with contributions deducted automatically from the employee's earnings;

2. **National Savings Fund**

2.1. Some sectors of the population have restricted or no access to retirement funding. The problem is acute not only for some employees in the formal sector, but especially for those in the burgeoning informal sector. National Treasury considers it a necessary challenge to provide such individuals access to an adequate retirement funding vehicle.

2.2. The reality is that many working-age South Africans experience periods during which they have no income and can only make irregular contributions to a retirement fund. The retirement funding system should be flexible enough to affordably allow for such contributions.

2.3. Table 3.1 below analyses working age individuals in terms of their likely sources of income during retirement:

TABLE 3.1.						
Employment status and earnings levels	Unemployed or not economically active. Earnings likely to be negligible. Transfer payments likely.	**Informal sector.** Earnings likely to be below tax threshold. Transfer payments possible.	**Formal sector earning below the tax threshold**	**Formal sector, earning more than the tax threshold but less than the SITE limit**	**Formal sector, earning more than SITE limit** Wide range of earnings.	**Formal Sector Independent contractors, self-employed professionals** Wide range of earnings, but earnings likely to be high.
Primary retirement provision	Pillar 1		Pillar 2			Pillar 3[13]
Taxpayer status	n/a	n/a	n/a	SITE taxpayer	PAYE taxpayer	
% of e.a.p. [14]	30%	20%	14,5%	23%	12,5%	
Access to:						
Social old age pension	Yes	Yes	**Some**[15] Reduced by means test.	**Little**[16] Reduced by means test	No (through application of the means test)	No (through application of the means test)
Occupational retirement fund	No	**No**[17] (unafforda ble)	**Possibly**[18] (unaffordable without cross-subsidy)	**Yes, if employer participates**	**Yes, if employer participates**	**No**[19]
Retirement annuity fund	No	**No** (unafforda ble)	**Possibly** (unaffordable unless ineligible for occupational fund)	**Possibly**	Yes	Yes
Private savings outside of their own home[20]	No	**Possibly** (but impacted by means test for social old age pension)	**Possibly** (but impacted by means test for social old age pension)	**Possibly**	Yes	Yes

[13] The World Bank model expects that Pillar 3 is used only for supplementary provision. Contractors and self-employed professionals are permitted access to Pillar 2 vehicles.

[14] Approximate proportions of the economically active population

[15] The social old age pension is reduced by R0,50 for every R1 earned. The social old age pension is zero once the person's income exceeds R1480 per month. It is highly likely that a person earning less than the tax threshold who has had a career of membership in an occupational retirement fund will lose a substantial part of the social old age pension. Viewing occupational retirement fund benefits and social old age pensions together, this represents an effective tax of R0,50 per R1 of income earned in excess of the threshold.

[16] See the previous footnote.

[17] The administration cost of operating an individual account for a member of an occupational retirement fund is equivalent to so large a percentage of likely savings for such a person that participation in an occupational retirement fund or a retirement annuity fund is not feasible.

2.4. The *Smith Report* and the *National Retirement Consultative Forum* recommended the establishment of funds that would be accessible to people employed in the informal sector, would permit irregular payments, from which drawings could be made in times of life crisis, but where retention for retirement should be incentivised. The *Taylor Report* recommended further investigation of this proposal.

2.5. The National Treasury Task Team proposes that:

2.5.1. For people with low incomes (particularly workers in the informal sector, part-time and seasonal employees, domestic and agricultural workers), a new savings vehicle, the National Savings Fund ("NSF"), should be created in consultation with bodies that have initiated other measures to encourage savings and the extension of banking services across the population. It is envisioned that this fund will provide a suitable retirement funding vehicle to many low-income workers, and possibly to individuals in the informal sector:

2.5.1.1. In order to enable such people to escape the poverty trap represented by the means test to the social old age pension, Government should exempt the benefits paid from the NSF from the means test.

2.5.1.2. The present disadvantages that such employees experience saving through an occupational retirement fund should be removed by incentivising savings through the NSF. It is envisioned that the NSF would:

(a) ensure affordable administration costs. Economies of scale should be achievable through the large numbers of subscribers to the NSF.

(b) pay competitive investment returns[21] with possibly a bonus being payable if moneys are retained in the NSF until retirement;

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[18] In an occupational retirement fund in which there is a broad spread of income levels, because the administration fee is expressed as a percentage of payroll, the more affluent members subsidise the administration cost of lower income members. The same issue as in footnote 19 applies if there are not affluent members in the fund.

[19] Under present law, if there is not an employer / employee relationship, an individual may not belong to an occupational retirement fund. By definition, these people do not have employer / employee relationships.

[20] A person's own home is exempt from the means test applied in respect of the social old age pension. Savings outside of one's own home experiences a considerable disadvantage where the social old age pension may otherwise be relevant because of the means test.

[21] These returns should at least correspond to the returns available on government bonds less expenses. If the bonus is payable on retirement, the return payable on withdrawal should be reduced so that the overall cost will be matched by the returns earned by the fund, nett of expenses.

(c) ensure wide accessibility across South Africa;

(d) require the administrator of the fund to permit irregular contributions;

(e) be exempt from the payment of Retirement Fund Tax[22]. This makes sense as the NSF would be likely to invest proportionately more of its assets in government bonds than a standard retirement fund. The taxation basis will essentially be a TTE[23] approach, but the target market will not pay tax, so it is essentially an EEE[24] approach for that market. The TTE approach should limit abuse of the NSF by the affluent.

Alternatively, abuse by the affluent can be limited by

(f) limiting the contributions into the NSF to a percentage of the tax threshold per individual saver or a fixed monetary amount; and/or

(g) deducting contributions made to the NSF from the tax-deductible contributions available for occupational and individual retirement funds; and / or

(h) deducting the interest payable from the NSF from the tax-free interest allowance for income tax purposes.

2.6. It must be noted that there is no consensus on all the points (a) to (h) above concerning the actual functioning and specific features of the NSF, but there is agreement concerning the creation of the NSF in principle.

3. **Differentiation**

3.1. Table 3.1 above reflects differentiation according to whether there is an employer / employee relationship. This effectively discriminates against

[22] This could create a situation in which an employee reaches retirement in an occupational retirement fund or an individual retirement fund and realises that, with hindsight, he or she would have been better off saving through the National Savings Fund. As they should always have been able to move from the occupational scheme to the National Savings Fund, this does not represent a poverty trap. It could also be made one of the duties of trustees to advise such employees to move, if it is clearly to their benefit to move.

[23] Contributions come from “after tax” income; investment build-up is taxed as private savings are taxed; and benefits are exempt from tax.

[24] No tax is payable on contributions or investment build-up in practice, if the member is below the tax threshold.

the self-employed unless there is harmonisation of the taxation of funds whether such a relationship exists, or not.

3.2. Funds commonly differentiate between benefits based upon age, gender and marital status, as well as employment status. Some of this differentiation is a natural result of the funding method. Some of the differentiation may suit the particular employees. It is therefore necessary to determine reasonability tests to establish what differentiation will be regarded as fair.

3.3. The *Mouton Commission* raised the issue of member-level discretion over the fund that should be joined. The National Treasury Task Team favours the choice of fund to be negotiated as part of an employee's conditions of employment.

3.4. The National Treasury Task Team considered the advantages in terms of cost control and cross subsidy across different types of member of having all employees in a single retirement fund. However, the National Treasury Task Team rejected such a constraint because in many situations there is a mix of unionised and non-unionised employees (and possibly even different unions). Additionally, some employees may fall within the scope of bargaining council agreements that require membership of bargaining council or bargaining-council approved funds. The unions may have negotiated participation of their members in union-sponsored funds and non-unionised employees may object to being forced to belong to such funds (or may not be eligible in terms of the rules of the funds). Likewise, in a sector in which there is a bargaining council, employees who are not governed by bargaining council agreements may object to being compelled to belong to bargaining council, or bargaining-council-approved funds. There will then inevitably be a multiplicity of funds. However, where there is an employer-sponsored fund, the National Treasury Task Team supports offering all non-unionised or non-bargaining council-covered employees membership of that fund.

3.5. The National Treasury Task Team recommends that:

3.5.1. For people with middle and higher incomes, particularly independent contractors and the self-employed, who are denied access to occupational retirement funds because there is no employer / employee relationship, conditions for favourable tax treatment should be harmonised for all types of retirement funds including those which do not operate in the context of an employment relationship.

3.5.2. Unfair discrimination should be addressed by:

3.5.2.1. Prohibiting restrictions placed on eligibility for membership on grounds of race, age, gender, sexual orientation, state of health or employment status;

3.5.2.2. Disallowing restrictions based on salary level or employment grade and inviting those employers who wish to make "top-hat" or special arrangements for their senior employees to do so by means of contributions to supplementary individual pension arrangements.

3.5.2.3. Prohibiting material differences in the relative value of the benefits[25] payable to members on the occurrence of defined events e.g. retirement at normal retirement age, early withdrawal *et cetera,* when such differences are attributable only, or mainly, to race, age, gender, sexual orientation or state of health. However –

(a) differences in risk benefits payable according to age, which result from the application of a funding method to all members; and

(b) restrictions in risk benefits for members on the grounds of physical condition, if this is reasonable in the context of the term of the fund's policy with an insurer, or if appropriate to ensure fairness and financial sustainability within the fund

should be permitted if –

(c) the premiums paid by funds for insurance products are determined with reference to the age, race and gender profile of the fund's membership. Funds will be required to ensure that the impact of such determination is not passed on to those with a poorer risk profile. Accordingly, funds must be prohibited from requiring different rates of contribution or providing different benefits to members if such practice amounts to discrimination on one or more prohibited grounds.

3.5.3. Members should have limited discretion in their choice of fund:

3.5.3.1. Unless an employee belongs to a category of employees in respect of whom membership of a

[25] That is, the present value of future benefits payable to all, on entry to the fund, must not be materially different for members of different races, ages, genders, sexual orientation or state of health. This will enable any statistical differentiation in terms of longevity, or probability of death or disability, to be accommodated by a change in benefit level.

particular fund is a condition of employment, the employee should be able to choose whether to join any occupational retirement fund in which the employer participates, or an individual retirement fund.

3.5.3.2. No employee who is below the tax threshold should be compelled to join an occupational or individual retirement fund and should be entitled to join the NSF instead.

4. Individual Retirement Funds

4.1. The emergence of individual retirement funds will be a natural consequence of harmonising the tax conditions applicable to retirement annuity funds and preservation funds with those applicable to occupational retirement funds, if instituted.

4.2. The National Treasury Task Team recommends that individual retirement funds which will emerge from this rationalisation process must:

4.2.1. not necessarily require an employer / employee relationship. The relationship will be between the member and the fund;

4.2.2. accept regular or irregular contributions (subject to limits established by tax law) and the amount of the benefit payable to the member would be determined on a defined contribution basis;

4.2.3. enjoy the same tax treatment as occupational retirement funds;

4.2.4. offer a choice of benefits and contribution rates within limits established by the management board of the fund, the sponsor, and the regulator;

4.2.5. allow transfer of retirement savings between funds at the request of the member, provided the fund to which the savings are transferred meets the conditions applicable to the first fund;

4.2.6. disclose all fees charged to prospective and existing members and to the fund by its service providers; and, in order to encourage competition amongst such service providers, the regulator must publish the comparative fees of the funds on offer;

4.2.7. provide fund members with a detailed annual statement disclosing *inter alia* all costs and fees charged, actuarial amount of withdrawal, net amount invested, average return per annum, and other such information as the regulator may prescribe; and

4.2.8. not pay commission or service fees to an intermediary for inducing a member to join the fund.

5. **Resulting Environment**

The recommendations made above are expected to simplify Pillars 1 and 2 of the system as follows:

	Unemployed	**Informal sector and workers in the formal sector who are below the tax threshold**	**Employees in the formal sector who are above the tax threshold**	**Self-employed and independent contractors**
	Pillar 1		Pillar 2	
Primary retirement provision	Social old age pension	Social old age pension NSF	Occupational retirement fund Individual retirement fund	Individual retirement fund
Supplementary retirement provision (Pillar 3)	NSF	Other savings through banks, collective investment schemes and insurance policies etc	Other savings through banks, collective investment schemes and insurance policies etc	Other savings through banks, collective investment schemes and insurance policies etc
Tax incentives	Modify the means test for the social old age pension and the NSF to eliminate disincentives.		All participants will be taxpayers, making it simpler to design an appropriate tax incentive strategy.	

6. **Ancillary benefits: insurance on death and disability; funeral benefits and post-retirement medical aid subsidy.**

6.1. Retirement funds have traditionally been used as vehicles through which members have accessed a range of ancillary benefits, thereby gaining economies of scale and collective treatment which have benefited lower income workers and those in poor health, giving them access to benefits in a cost-effective manner which otherwise might be denied to them[26]. It has

[26] Bulk sale (to all the employees covered under a retirement fund), premium collection by payroll deduction, communication through the employer's human resources department and claim submission through the

also facilitated the provision of ancillary benefits through a vehicle arguably subject to better regulation than most alternative vehicles through which they could be provided.

6.2. This practice has been supported by the *Smith Report* in respect of funeral benefits, and the *Taylor Report* in respect of death and disability benefits. The *Taylor Report* in fact recommended that funds be compelled to provide minimum death and disability benefits.

6.3. The provisions of the Income Tax Act and the Pension Funds Act have inhibited the inclusion of some of these ancillary benefits within a retirement fund. For very large employers, this did not matter, because the employer could gain cost-effective access through a policy between the employer and an insurer. This is not cost-effective for small employers who often access such benefits through umbrella retirement funds.

6.4. Employers and industry practitioners have complained that none of the current legal arrangements provide a suitable vehicle for the pre-funding, by employees, employers or both, of post-retirement medical aid contributions. The Katz Commission and the “taxation” subcommittee of the National Retirement Consultative Forum supported the use of retirement funds as the most appropriate vehicle for such provision.

6.5. The National Treasury Task Team proposes that:

6.5.1. The barriers that are currently in the Income Tax Act and the Pension Funds Act, which prevent the provision of ancillary benefits through a retirement fund, be removed. However, the legislation should encourage effective costing and ring-fencing of such benefit, to ensure that the underlying objective of saving for retirement is not undermined. The management board of a retirement fund should be able to package any benefits they feel are appropriate, with retirement savings, in a single retirement fund, provided that:

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employer, make some benefits far cheaper for the consumer if packaged with retirement benefits than if they were sold individually. This applies to the insurance of death and disability risks and funeral benefits for the employee and his or her immediate family.

By providing death and disability insurance to <u>all</u> employees covered by a retirement fund, insurers are able to offer certain additional features: a medical free limit and a premium rate which is expressed as a percentage of payroll.

(a) All members will receive cover up to the medical free limit without having to undergo medical testing; any cover in excess of the medical free limit is provided by the insurer only if the member’s state of health is satisfactory or an additional premium is paid.

(b) There is strong statistical evidence that the probability of death or disability rises as income falls. If everyone obtained cover individually, the affluent would get cover cheaper and the poor would pay relatively more. By expressing the premium for a group such as a retirement fund in the form of a percentage of payroll, everyone pays the same rate. This benefits lower income workers.

6.5.1.1. At least a prescribed minimum percentage of the total contributions made to the fund must be applied towards retirement savings.

6.5.1.2. The members of that fund must be informed of the breakdown of the total contribution paid between retirement savings, administration expenses, and insurance premiums, and

6.5.1.3. The contribution paid towards retirement savings may not be able to be reduced as a result of increases in administration expenses or insurance premiums. Instead, the insured benefit levels must be appropriately reduced.

6.5.2. An employer who wishes to pre-fund the medical aid contributions which it is obliged to make in respect of pensioners, should be able to use an occupational retirement fund for this purpose with certain special features covering such funding:

6.5.2.1. The fund may limit payment of the pre-funded benefit only to those who remain in the fund until retirement and then only for so long as they remain members of a medical scheme.

6.5.2.2. The contribution that the employer makes towards such funding is subject to limits determined by the revenue authorities, in conjunction with the regulator.

Annexure 3

BENEFITS, CONTRIBUTION RATES AND MEMBER PROTECTION

1. **Adequacy of Retirement Benefit**

1.1. Government's objective in terms of adequacy is as follows:

1.1.1. Members should be able to accumulate sufficient assets to provide an income after retirement at age 65, from a combination of the social old age pension and a retirement fund, of 75%[27] of earnings in the year before retirement for a low income member, with the possibility of a lower percentage applying at higher income levels.

1.1.2. The resulting retirement income should -

1.1.2.1. retain purchasing power in the face of inflation,

1.1.2.2. be payable for the lifetime of the member,

1.1.2.3. include a pension payable for the lifetime of the surviving spouse on the member's death after retirement of 50% of the member's pension,[28] or an equivalent pension to be paid to any dependant children until the age of 18, if there is no surviving spouse.

1.2. Government recognises that other demands, such as the financing of housing and education, often take priority in the earlier part of a person's working life. While earlier savings are strongly encouraged, the limits on tax-deductible contributions should be set to enable achievement of the objective with contributions starting at age 40. Lower limits may be appropriate for those who start retirement saving earlier in their working lives.

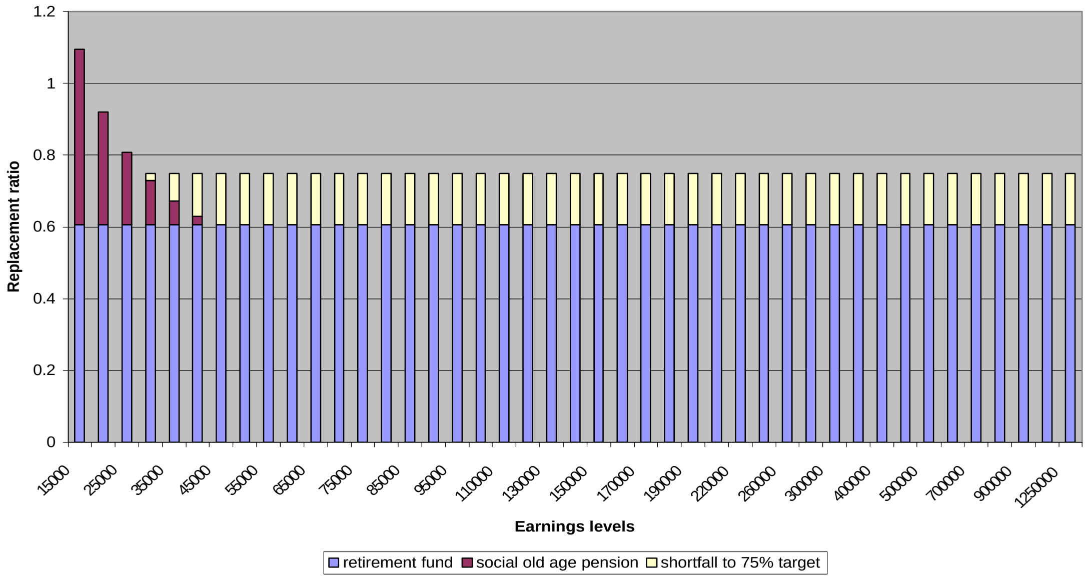
1.3. Modelling has demonstrated that Government's objective can be achieved through a combination of the social old age pension (with modification of the means test) and savings accumulated in one or more retirement funds.

1.3.1. A retirement savings contribution of 22,5% of remuneration (after expenses have been deducted from the contribution) from age 40 to age 65, and an amended means test, reducing

[27] Countries such as the UK, France, and Germany have replacement rates from their social security system between 40% and 50% of average earnings. This is supplemented by private funds.
[28] By assuming all people are married and a pension of this level is payable to a surviving spouse, implicit provision is included for a pension to orphans if there is no surviving spouse.

the social old age pension by R0,50 for each R1 of income earned over R10 000 per annum, the Government's objective may be achieved for pensioners retiring at lower income levels. Higher income employees will achieve pensions of 60% of earnings. The replacement ratios that would be achieved are indicated in the following graph:

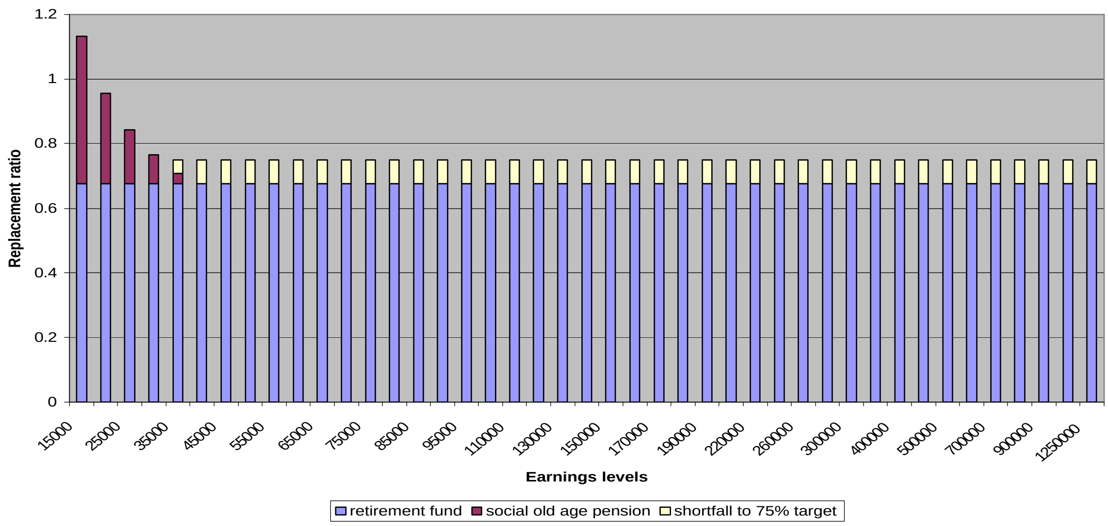
Replacement ratio: accumulation of 22,5% of payroll, after expenses, at a 3% real return, for 25 years, converted to pension at a rate of R13,8 for R1 of pension, with reduction of the SOAP by R0,50 for each R1 of income earned over R10 000 p.a.



1.3.2. Lower levels of contribution will achieve similar objectives if saving commences at a younger age. For example, if a member and his/her employer save 12,4% of payroll from age 25 to age 65[29], the replacement ratio will be as follows:

[29] The average figures from the Sanlam 2002 Survey in respect of defined contribution funds were a contribution from member plus employer of 16,8% of remuneration, from which 1% was deducted for administration expenses and 3,4% was deducted for death and disability insurance premiums, giving the nett amount saved for retirement of 12,4% of pensionable earnings. The figures are somewhat lower for the Sanlam 2004 Survey, with expenses having increased to 1,4% for administration and 4,3% for death and disability insurance premiums, leaving the nett amount saved for retirement of 10.8%

Replacement ratio: accumulation of 12.4% of payroll, after expenses, at a 3% real return, for 40 years, converted to pension at a rate of R13,8 for R1 of pension, with reduction of the SOAP by R0,50 for each R1 of income earned over R10 000 p.a.



1.4. Some jurisdictions have addressed this issue by limiting tax-deductible contribution rates by age[30].

1.5. National Treasury recommendations on this section concerning the maximum tax-deductible contribution towards retirement savings by member and employer combined are to be elucidated at a later stage.

2. Pension Increases

2.1. The Pension Funds Second Amendment Act, 2001, introduced a requirement that each pension fund establishes, implements, and communicates a policy which targets a level of price inflation. Statutory minimum pension increases must be applied to pensions, at least once every three years, to a minimum of the lower of the change in the Consumer Price Index from date of retirement to the date of the increase, and the increase that the fund can afford based on the nett investment return earned on the assets backing the pensioner liabilities.

2.2. If a fund's pension increase policy targets less than full inflation-proofing (with the corresponding determination of the assets that back the pensioner liabilities), too low a return may be earned by the fund on these assets to enable it to give full inflation-proofing.

2.3. The *Taylor Report* recommended that all funds be required in their rules to provide inflation-adapting pensions and a specific mechanism for determining pension increases. The Pension Funds Second Amendment

[30] For example, the Republic of Ireland: below age 30, 15%; age 30 to 40, 20%; age 40 to 50, 25%; over age 50, 30%.

Act, 2001, compels the fund to give full inflation-proofed increases if the fund can afford them. It therefore does not compel full inflation-proofing without proviso. The National Treasury Task Team is concerned that the potential cost of such compulsion (without the affordability proviso) could jeopardise the financial stability of some funds. Employers and existing members would have to fund significant shortfalls that would arise as a consequence. Accordingly the National Treasury Task Team would prefer that the pension increase policy is determined by a fund's trustees in consultation with stakeholders.

2.4. The National Treasury Task Team recommends that:

2.4.1. The provisions of the Pension Funds Second Amendment Act, 2001, be preserved in the new legislation, with any problems of implementation being suitably addressed.

2.4.2. If a fund's liability to pay pensions is not underwritten by an insurer, the assets required to back the liability must be invested separately from the other assets of the fund and pensioners must receive the benefit of the investment return earned on these dedicated assets.

3. Benefits Available from a Retirement Fund

3.1. In considering the benefits available to members, the National Treasury Task Team considered two different options:

3.1.1. The "savings only" option, in which the retirement fund is a pure savings scheme for the member and any ancillary benefits are provided by the member, or by his/her employer, trade union or bargaining council, as the case may be, by means of insurance policies in the name of that entity; and

3.1.2. The "package" option, in which a retirement fund offers a package of benefits covering early withdrawal, retirement, death or disablement of the member, and his/her immediate family in the case of funeral benefits. All of these benefits are protected against claims by the member's creditors or heirs for as long as there is a member or dependants entitled to them.

3.2. The "savings" option has the advantage that it is very simple and likely to promote cost-effective administration. However, individuals are unlikely to be able to obtain the ancillary benefits at comparable rates to those they would enjoy under the "package" option[31]. Furthermore, the "package" option, which is currently widely used, serves a number of useful purposes

[31] When ancillary benefits are secured for all members of a retirement fund there are economies of scale (because of the collection of premiums by salary deduction, remission of a single payment to the insurer, and the ease of communication through the fund/employer) and cross subsidies (usually across members of different ages because the same price is paid by all members as a percentage of remuneration) which make the benefits cheaper on a group basis than they would be individually. See footnote 28.

in the South African context[32]: in particular, it promotes the protection of the most vulnerable in our economy, the elderly, the disabled and the dependants of deceased members by requiring trustees to investigate the relative financial security of the deceased's dependants and to allocate insolvency-immunised benefits payable on his / her death on an equitable basis.

3.3. The practical experience of employers and management boards is that the members welcome the use of retirement funds to ensure that a minimum package of benefits is available on death and disability, the investment of assets is appropriate, and death benefits are distributed on an equitable basis between dependants.

3.4. The National Treasury Task Team recommends that the "package" option is adopted in the South African context, subject to certain constraints:

3.4.1. The management board of a retirement fund should be required to:

3.4.1.1. structure a cost-effective benefit package utilising the full range of employee benefits available in the market place provided that every fund has a meaningful retirement savings component, which is separate from any ancillary benefits included. This component may not be reduced if the costs of the ancillary benefits rise (even if this means that the ancillary benefits must be reduced if the insurance premiums rise)[33];

3.4.1.2. ensure that the allocation of the total contribution rate between retirement savings, administration costs, and insurance premiums is set out in the rules and disclosed to members (as must be any

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[32] The following factors should be considered in the context of South Africa: We have

(a) a substantial proportion of low income workers
  - (i) who have little financial education and therefore may purchase inappropriate financial products,
  - (ii) who have, in their individual capacity, little negotiating power with financial institutions,
  - (iii) who are likely, in their individual capacity, to make investment and other choices that are inappropriate (most likely because they are too conservative) and who would do better to have these decisions made on their behalf by management boards who can access appropriate expertise, and
  - (iv) who need the bulking of transactions, such as insurance, to obtain economies of scale and cross-subsidies;

(b) common multiple marriage or marriage-like relationships,

(c) dependants from more than one of these relationships (not all of whom may be acknowledged in any beneficiary nomination), and

(d) a significant proportion of the population has little practical experience of testamentary distribution and relatively small amounts of money available outside their retirement fund.

[33] National Treasury wishes to avoid members retiring with an inadequate benefit because costs have eroded their savings. If costs rise, stakeholders should renegotiate the benefit package, before the savings element is reduced.

reduction of ancillary benefits[34] following premium increases);

3.4.1.3. ensure the competitiveness of the administration costs and insurance premiums; and

3.4.1.4. ensure that any benefits are distributed in accordance with the member's nomination of beneficiary form, unless compelling reasons exist why this should not be followed. Legislation may prescribe the type of annuity that must be used and any contingent pensions payable to the member's spouse or dependants following the member's death after retirement. Legislation should permit the management board to pay benefits into a discretionary trust established for the benefit of the member and/or his/her dependants.

3.5. Minimum rates of contribution

The National Treasury Task Team recommends that no minimum rates of contribution should be prescribed in legislation.

3.6. Fluctuating rates of contribution

3.6.1. The revenue authorities currently require that the contribution paid by a member must be fixed in terms of the rules for the category of membership to which the person belongs. Variable contribution rates are not permitted. This constrains the payment of additional contributions by members to enhance their retirement savings.

3.6.2. Most members of occupational retirement funds and individual retirement funds are likely to be taxpayers (see the analysis in chapter 2), which means that either a tax return will be filed, or the employer will determine SITE taxation independently of the member. It would therefore be possible to relax the constraint presently imposed by the revenue authorities subject to the overall tax deductibility limits.

3.6.3. The National Treasury Task Team recommends that, subject to the rules of the fund in which they participate, members may vary their contribution rates, provided the limit on the tax deductible contribution by member and employer combined is not breached.

[34] There are currently administration systems which are capable of managing such changes.

3.7. Form of Benefit Payment

3.7.1. A substantial proportion of existing retirement funds pay their entire retirement benefit in the form of a lump sum (Such funds are known as “provident funds”).

3.7.2. The National Treasury Task Team favours the payment of benefits in the form of an income[35] after retirement, disability or death. The National Treasury Task Team also recognises, however, that many retirees need lump sums in order to settle debt. The new Retirement Funds Act should therefore prescribe the payment of only a modest proportion of the benefit in the form of a lump sum, with the balance being used to secure an annuity. If this recommendation is accepted, the rules of some provident funds will have to be changed to require the purchase of annuities.

3.7.3. The National Treasury Task Team recommends that:

3.7.3.1. Benefits should be taken in the form of an income, with modest proportion of the benefit in the form of a lump sum. Specific limits and tax proposals in this regard will be formulated by the National Treasury at a later stage.

3.7.3.2. Existing provident funds be given a reasonable period in which to amend their rules to cater for the revised dispensation.

[35] The Task Team is concerned that:

(a) The purpose of a retirement fund is to produce income during retirement or disability or for the member’s dependants after the member’s death. Payment of the retirement benefit in lump sum form only may frustrate this purpose unless the recipients invest the proceeds appropriately. With levels of financial sophistication amongst retirees being low, they are easy targets for vendors of unscrupulous schemes. There are also doubts that appropriate protection is included for the retiree’s dependants when such investments are made.

(b) Most people who retire in good health underestimate their longevity. With improvements in medical care and general living standards, most countries in the developed and developing world are experiencing dramatic improvements in longevity. This is believed to be happening currently in South Africa amongst affluent retirees. In the long-run, if this were to be symptomatic of the entire population, this risk is best left to a well-capitalised and regulated insurance industry.

(c) If the sick are able to take their benefits in the form of lump sums, and those who are going to live long future lives buy annuity policies, the cross subsidy which enables all to buy annuity policies at “average” rates will disappear and insurers will price annuity policies expecting longer than average life spans. This will not be to the benefit of the average retiree.

3.8. Post Retirement Medical Funding

3.8.1. Many employers have an obligation to subsidise the medical aid contributions of employees who retire from their service. With the introduction of accounting standard, AC116, employers have been obliged to reflect their contingent liability in respect of these obligations in their balance sheets unless they establish a separate plan for the funding of these obligations. Employers use this separate plan to fund their obligations during the working lives of employees, or over a defined period in the case of pensioners. As future medical aid contributions are difficult to predict, if there is any over-provision, the employer should have the right to recover such an amount.

3.8.2. The Katz Commission recommended that a retirement fund is the most suitable vehicle in which such funding may take place.

3.8.3. The Pension Funds Second Amendment Act, 2001, authorised the establishment of an "employer surplus account" in which the employer could accumulate moneys to be used to satisfy such obligations through the purchase of additional pensions or deferred pensions.

3.8.4. The National Treasury Task Team recommends that:

3.8.4.1. An employer be permitted to make contributions to the "employer surplus account" with the express purpose of funding post retirement medical aid obligations, within limits to be determined by the revenue authorities, in conjunction with the regulator.

3.8.4.2. Members acquire no rights to any part of this account, unless they retire from the service of the employer in circumstances, which entitle them to subsidy of their medical aid contributions. In such circumstances, the employer could authorise the payment of sufficient capital from the special account to secure an annuity for the retired member. This annuity may either be paid from the fund or purchased from an insurer. Alternatively, the retiree's medical aid contributions could be paid from that account and such payments could cease if the member, for example, leaves the country and is no longer a member of the employer-nominated medical scheme.

3.9. **Leakage**

3.9.1. An analysis of benefit payments and anecdotal evidence strongly suggests that the primary causes of poverty in old age, of people who have worked in the formal sector throughout their careers and who have been a member of one or other occupational or individual retirement fund, are:

3.9.1.1. the failure of many retirement funds in the past to pay adequate early withdrawal benefits; and

3.9.1.2. the drawing of benefits in cash when changing jobs and the failure to invest this money for their retirement.

Such leakage from the retirement funding system has detrimental effects on the replacement ratio on retirement.

3.10. **Minimum Benefits**

3.10.1. The Pension Funds Second Amendment Act, 2001, introduced a minimum benefit regime, which is designed to ensure that the fund pays an adequate benefit whenever a member leaves service, defined as the member's "minimum individual reserve"[36]. In accordance with the Act, all retirement funds should be paying this minimum benefit from 12 months after their first statutory actuarial valuations following 7 December 2001, implying that, by 7 December 2005, all members of retirement funds subject to the Pension Funds Act will benefit from the minimum benefit regime. There are drafting and implementation problems in the minimum benefit provisions, which need to be addressed.

3.10.2. The National Treasury Task Team recommends that the minimum benefits regime introduced in the Pension Funds Second Amendment Act, 2001, be preserved in the new Act.

3.11. **Loss of Employment**

3.11.1. The loss of employment can be traumatic and impose severe hardship, especially if the member is unemployed but is not permitted to access his / her retirement savings.

3.11.2. The *Taylor Report* recommended that an employee be permitted access to their retirement savings only after the

[36] In the case of a defined contribution fund, the "minimum individual reserve" will be the sum of the member's own contributions, any contributions paid by the employer, and the investment return earned by the fund, nett of expenses. In the case of a defined benefit fund, the "minimum individual reserve" will be defined in the Act, and will represent an amount of money, which, if invested prudently, should grow to be sufficient by retirement age to replace the defined retirement benefit.

Unemployment Insurance Fund (UIF) benefit had been exhausted. The National Treasury Task Team supports this principle, but acknowledges that it is reliant on the efficient functioning of the UIF.

3.11.3. The National Treasury Task Team is still considering policy proposals with regard to a loss of employment. The National Treasury Task Team however recommends compulsory preservation on a change of employment however (see 3.12.1 below).

3.12. Preservation and Portability

3.12.1. In line with the recommendations of the various commissions, National Treasury wishes to discourage leakage by forcing preservation of benefits on a change of jobs, but allowing the member choice as to the fund in which the benefits are preserved.

3.12.2. Expenses in the transfer must be minimised.

3.12.3. The National Treasury Task Team recommends that if an employee changes jobs and ceases to be eligible to belong to his/her old retirement fund:

3.12.3.1. The benefit payable from the old retirement fund must not be available in cash but must be transferred to the employee's new occupational retirement fund, an individual retirement fund of the employee's choice, or the National Savings Fund, with the choice of transferee fund being made by the member.

3.12.3.2. The member must give reasonable notice to the fund.

3.12.3.3. If the member has not informed the old retirement fund of his/her election of receiving fund within a reasonable period, the old retirement fund may transfer the money to an individual retirement fund selected by the board of trustees of the old retirement fund and inform the member accordingly. [As the member has the option to transfer between individual retirement funds without charge, the member may move this money at any time thereafter.]

3.12.3.4. The transferor fund may not deduct any expenses from the member's benefit.

3.12.3.5. No party may reward, directly or indirectly, any person for inducing the member to transfer his/her savings to the transferee fund.

3.12.3.6. The whole, or a portion, of the benefit may be paid in cash under one, or both, of the following circumstances:

(a) where the amount involved is lower than a minimum amount determined by the regulator; and/ or

(b) where the fund has guaranteed a member's housing loan, and the member defaults, in which case the retirement fund must pay as much as possible of the outstanding loan (after the deduction of tax), and pay any residual amount (after the deduction of tax, if appropriate) to the National Savings Fund on behalf of the member.

3.13. **Interest on Late Payment of Benefits**

3.13.1. Many former members are currently not paid any form of interest from the date they leave the fund until the date of payment of the benefit. This penalises the former member to the potential advantage of remaining members.

3.13.2. The National Treasury Task Team recommends that once a claim is admitted and the member's interest in the fund is converted into cash, the management board should be required to invest this amount in an interest bearing account and pay the interest earned when the claim is settled.

3.14. **Unclaimed Benefits**

3.14.1. Historically, many former members were denied their benefits immediately upon leaving service[37]. Many of these individuals failed to maintain any contact with their former fund or employer, and the records held by the retirement fund were inadequate to facilitate tracing them and effecting payment. The usual rules of prescription applied, hence, provided that the members had been aware of their right to claim a benefit and had failed to exercise that right, the right lapsed after three

[37] There were several reasons for this:
(a) the rules included a waiting period before they were entitled to payment (intended originally to discourage drawing retirement savings for immediate consumption needs)
(b) many such members belonged to industry funds and there was an expectation that they would seek employment in the same industry – retention of the moneys potentially meant that service could continue with another employer without loss of benefits, and
(c) many funds did not pay a cash benefit but rather deferred benefits until retirement.

years. As this was to the advantage of the fund, participating employer and/or remaining members, many funds did not put sufficient effort into tracing their former members.

3.14.2. The National Treasury Task Team argues that such unclaimed benefits do not belong to the fund. A concerted effort is required, independent of the fund, to trace former members and their dependants.

3.14.3. The National Treasury Task Team recommends that:

3.14.3.1. The board of management of a retirement fund should be required to attempt to locate any individual or his/her dependants who are entitled to benefits under the retirement fund. After a period of no more than, say, 24 months after benefits become due to a former member, the corresponding value should be paid to a central "unclaimed benefits fund".

3.14.3.2. The central "unclaimed benefits fund" must have a duty to trace former members and endeavour to make payment to them or their dependants.

3.14.3.3. If the central fund is unsuccessful in tracing the former members or their dependants (if the former member passed away), the central fund may release moneys to the State in order to fund, for example, the social old age pension.

3.14.3.4. If any former members or relatives of deceased members come forward thereafter and successfully substantiate their claim, the central fund may make the benefit payment.

3.15. Access to Retirement Savings During Employment

3.15.1. Housing loans and guarantees

3.15.1.1. The *Mouton Report* suggested the incorporation of housing finance benefits into retirement funds because the single most important influence on income inadequacy in retirement is ownership of a home. The *Taylor Report* favoured the use of retirement savings to pay off housing mortgages while members are below the age of 40.

3.15.1.2. Currently, Section 19 of the Pension Funds Act permits a fund to grant a housing loan, or to provide a guarantee in respect of a member's housing loan from another institution, subject to a maximum amount equal, effectively, to the resignation benefit available to the member, nett of tax. If the member defaults on a loan provided by another institution which has been guaranteed by the fund, the board of the fund may disinvest the cash resignation benefit at date of default and use the proceeds, nett of tax, to repay the loan. The member's retirement benefit is then reduced accordingly. Many thousands of members have utilised such a facility to access housing finance that would otherwise have been denied to them.

3.15.1.3. The National Treasury Task Team is concerned that some retirement funds grant loans to members and therefore essentially engage in housing finance business. This is not consistent with the principal purpose of retirement funding, not within the expertise of trustees and may entail inappropriate risk and use of resources. It is also believed that, as the only reason retirement fund resources should be permitted to be used as collateral for housing finance is to allow access to such finance to low income earners, the amount of any guarantee should be subject to a specified rand value. Higher income members should be eligible for top-up housing finance without a pension-backed guarantee. In sum, the National Treasury Task Team is of the opinion that allowing only housing guarantees by a fund and not loans, will not inhibit a member from obtaining the necessary financing for their home.

3.15.1.4. The National Treasury Task Team therefore recommends that *only* housing guarantees continue to be permitted subject to the following conditions:

(a) At the time of initial approval of the guarantee, the amount of the loan guaranteed by the fund must not exceed the member's minimum individual reserve, less tax and subject to a maximum of a specified rand amount – which will have to be adjusted from time to time by regulation.

(b) The terms of the underlying loan by the third party must require its repayment before retirement age, or the cash amount available on retirement, nett of tax, should be expected to be sufficient to pay the outstanding loan and any interest still owing.

(c) There must be full disclosure of the material terms of the underlying loan including payment period and interest rate, to the member and the fund.

(d) If the member defaults on the interest payments, the amount outstanding should be deducted from the member's retirement savings so as to ensure that interest accumulating on the loan cannot extinguish the eventual retirement fund benefit.

(e) The property in respect of which the loan is taken must be limited to the member's primary residence and his or her spouse's primary residence, if they are not the same.

(f) Strict controls must be in place to prevent abuse.

3.15.2. **Other life crisis needs**

3.15.2.1. No other type of loan or payment to a member is permitted during employment in terms of the Pension Funds Act.

3.15.2.2. The National Treasury Task Team considers that drawing off retirement savings for life crisis needs is likely to be necessary for workers in the informal sector and may affect those earning low incomes in the formal sector. These people are least likely to have access to other forms of finance.

3.15.2.3. The National Treasury Task Team recommends that:

(a) An occupational or individual retirement fund must not be permitted to provide loans or guarantees for any purpose other than housing.

(b) The National Savings Fund should permit withdrawal of savings for any purpose, but incentivise retention for retirement by paying an enhanced rate of interest if moneys remain invested until retirement.

(c) If a member is terminally ill and the fund provides an income on disability with the person remaining covered under the fund's insurance policy for a death benefit in excess of the retirement savings account, the insurer should be permitted to accelerate payment of the insured portion of the death benefit.

3.16. **Deductions**

3.16.1. Other than housing loans provided either by the fund or by the employer, or amounts in respect of any defaults on housing loans guaranteed either by the fund or by the employer, the Pension Funds Act permits deductions from benefits only in restricted circumstances:

3.16.1.1. amounts due to the employer as compensation for any damage caused to the employer by reason of theft, dishonesty, fraud or misconduct by the member, where the member has admitted liability in respect of the compensation due in writing, or judgment has been obtained in any court;

3.16.1.2. payment of medical aid contributions, or insurance premiums, or other purposes approved by the regulator, by arrangement with, and on behalf of, the member.

3.16.2. The deduction of amounts and payment to the employer in terms of paragraph 3.16.1 are contrary to the principle underlying the "package" option, namely that retirement savings are intended for the protection of the member and his / her dependants. Retirement savings do not form part of the estate of the member unless neither the member nor any dependants are able to benefit.

3.16.3. A consequence of this approach is that deductions at the request of the member, which have the effect of giving priority to certain claims against the member such as medical aid contributions and insurance premiums, cannot be permitted. Rather the member must receive the benefit, less tax, and pay these expenses separately.

3.16.4. In order to prevent deliberate abuse of the system, through, for example, the payment of voluntary contributions into the fund to avoid claims by creditors, the management board of the fund must be able to determine and pay out such voluntary contributions plus the nett investment return earned thereon.

3.16.5. The National Treasury Task Team recommends that:

3.16.5.1. The only deductions permissible on the exit of a member from a fund be in respect of tax and housing loans or guarantees.

3.16.5.2. The management board of the fund be permitted to refund voluntary contributions plus the nett investment return earned thereon to the member's estate.

3.16.5.3. The balance of the member's interest in the fund must be applied, under the direction of the management board (guided by the member's nomination of beneficiary form in case of the death of the member). In the absence of a nomination of beneficiary form, the member's remaining benefit is to be distributed in accordance with his/her will.[38]

3.17. Divorce

3.17.1. Currently the only portion of the member's interest in the fund that is considered part of his or her distributable estate on divorce is the cash lump sum benefit to which the member would be entitled if he or she resigned at the date of the divorce. Any portion awarded to the former spouse is payable when the benefits accrue to the member. No growth on the share allocated to the former spouse is payable. This cash resignation benefit may be considerably smaller[39] than the member's full interest in the fund. Future restrictions requiring payment of any benefit in the form of instalments may potentially complicate the inclusion of such an amount.

3.17.2. The *Mouton Report* and the SA Law Commission recommended the treatment of pension benefits in accordance with what is described as the "clean break" principle: at the date of the divorce the pension benefits of each of the member and his/her spouse are determined and divided between the two parties. The non-member spouse then effectively becomes a member with a benefit corresponding to the share awarded to him/her; and the member's benefit is correspondingly reduced.

3.17.3. The National Treasury Task Team recommends that:

[38] Benefits should be paid to the designated beneficiaries, except where the law specifically requires an amount to be paid to a surviving spouse and/or beneficiaries of the member.
[39] Although the gap will narrow very considerably once the minimum benefit regime applies to the fund.

3.17.3.1. The member's minimum individual reserve should be deemed to form part of his / her assets available for splitting on divorce.

3.17.3.2. If the court orders the division of this reserve, the member's minimum individual reserve must be split between the member and the member's former spouse on the basis determined by the court.

3.17.3.3. The benefit due to the member from the fund in respect of service prior to the divorce should be reduced in the proportion that the residual amount of the member's minimum individual reserve bears to the member's minimum individual reserve immediately prior to divorce.

3.17.3.4. The member's former spouse should thereafter be deemed to be a member of the fund with a paid up minimum individual reserve equal to the portion awarded by the court. If left in the fund, the member's former spouse's benefit will grow with investment return on a defined contribution basis. The member's former spouse should also be given the option to require the transfer of his/her share to an individual retirement fund or an occupational retirement fund, in which he/she participates.

3.17.3.5. The member's former spouse will thereafter have no claim against the member's residual interest in the fund.

3.18. **Payment of benefits on death**

3.18.1. Section 37C of the Pension Funds Act, which requires the management board of a fund to distribute the moneys available on the death of the member between the member's dependants and nominated beneficiaries on a basis it deems equitable has been strongly criticised. However, the principle that the management board should have such a responsibility seems to be welcomed by stakeholders and is consistent with the "package" option recommended by the National Treasury Task Team. The management board is perceived, in effect, to be performing a valuable social service by exercising its investigatory and distributive functions. On the other hand, critics of the section say that it is overly paternalistic.

3.18.2. Payment of benefits to dependants and nominated beneficiaries in the form of an income should be encouraged with only a modest proportion being available in the form of a cash lump sum.

3.18.3. The National Treasury Task Team recommends that:

3.18.3.1. Trustees should be obliged to –

(a) require fund members, at least once every five years, to state in writing the identity of all their dependants, both financial and legal, and to specify the persons to whom they wish the benefits payable upon their deaths to be paid.

(b) comply with the expressed wishes of the deceased member unless, in their opinions, there are compelling reasons why they should not.

3.18.3.2. Process difficulties which are evident in section 37C of the Pension Funds Act should be minimised in new legislation.

3.18.3.3. Benefits should be paid to dependants and nominated beneficiaries in the form of an income unless the benefits are so small as to make such payments cost inefficient. If a board determines that a dependant is not capable of responsibly managing the income, the management board should have the right to establish a trust into which the benefit could be paid and managed for the benefit of the dependant.

3.19. **Payment of Benefits on Disability**

3.19.1. Currently a retirement fund may not pay an income on temporary disability to a member without losing its status as an approved fund for tax purposes. Many employers purchase short-term or long-term disability benefit policies to provide these benefits to their employees.

3.19.2. The *Taylor Report* recommended the payment of such disability benefits by retirement funds (in fact the *Taylor Report* proposed that a minimum disability benefit equal to an income of 60% of the member's earnings before disability be mandatory).

3.19.3. The National Treasury Task Team recommends that:

3.19.3.1. Retirement funds be permitted to pay an income on temporary[40] and permanent disability without losing its status as an approved fund for tax purposes.

3.19.3.2. No minimum benefit be prescribed, as the nature and level of benefit should be negotiated.

[40] There is no consensus as to whether payment for temporary disability should be allowed.

Annexure 4

GOVERNANCE AND REGULATION

1. Powers of the Regulator

1.1. Funds registered in terms of the Pension Funds Act ("the Act") are subject to regulation in terms of it, including supervision by the Registrar of Pension Funds through the Financial Services Board ("the FSB"). Bargaining Council funds are not subject to such regulation but are regulated to a minimal extent by the Department of Labour. While local authority funds are registered in terms of the Act and accordingly subject to the same regulation as private sector funds, the funds to which –

1.1.1. State employees belong, including the Government Employees Pension Fund, and the Associated Institutions Pension Fund; and

1.1.2. certain State enterprise employees belong, such as the Telkom Pension Fund and the Transnet Pension Fund,

are excluded from that regulation. Their members have no right of recourse to the Pension Funds Adjudicator ("the Adjudicator").

1.2. While it is arguable that State and State enterprise funds do not require financial regulation because they are effectively guaranteed by the State, this argument does not justify denying the members of those funds the benefits of good governance standards required of, and effective dispute resolution granted to, members of those funds which fall under the Act.

1.3. Funds registered in terms of the Act are subject to regulation concerning funding requirements, the content of their rules, the audit and/or statutory valuation of the funds, information to be provided on application for registration of a fund, prudential investment limits, the licensing of fund benefit administrators and asset managers, the reporting of any non-payment of contributions, and the apportionment of actuarial surpluses.

1.4. The Registrar has limited enforcement powers: namely, the legal standing to take legal action to recover monies unlawfully removed from funds, to seek the replacement of a board of trustees with curators in limited circumstances, and to levy a modest fine on a fund which fails to lodge documentation on time. The Registrar has been hard pressed to ensure effective governance in a complex industry comprised of specialist service and product providers, consultants and thousands of funds. It is essential that the regulator have the power to fine, suspend or remove a retirement fund trustee, and to fine and/or withdraw the license of a service or product provider, who fails to fulfil his/her duties. The Adjudicator's jurisdiction is limited and he is unable effectively to sanction the members of a board of trustees, a fund's advisors and other service providers. Furthermore, the regulator is unable to refer disputes to the Adjudicator for determination.

1.5. Improvements are required to even the regulation of funds under the FSB's jurisdiction. The regulator does not have the human resources capacity to properly fulfil all its current duties in terms of the Act. These include the checking of all new fund rules, all rule amendments, financial statements, valuation reports, transfer schemes and surplus apportionments. Some of the standards required for such checking are more onerous than any regulator could possibly satisfy (such as a requirement to decide whether schemes for the transfer of assets and liabilities are "reasonable and equitable", which to perform properly requires in-depth investigation of each instance, which is impractical when there are about 4500 transfers processed in the regulator's office each year). The problem should arguably not be addressed by increasing the personnel of the regulator, but by setting standards and licensing external specialists to perform work in terms of those standards, with on-site visits to check compliance. The regulator should then check that an appropriate process is followed, through confirming that certification of the process has been included with the application. An effective disclosure and dispute resolution mechanism should enable aggrieved parties to challenge the actions of boards of funds.

1.6. There are many consultative bodies with responsibility for making recommendations on policy which may affect occupational retirement funding without clarity on how conflicting interests between representatives of stakeholder groups are to be managed. These include the Policy Board for Financial Services and Regulation, the Pension Funds Advisory Committee, and the committees established to supervise the work of the regulator in terms of the Financial Services Board Act, 1990. In practice the Registrar and the Minister, either independently or through NEDLAC, also consult labour and business before making significant changes to legislation or subordinate legislation. Greater clarity is required on what changes by board notice require ministerial consent and what may be made by the regulator without it.

1.7. The FSB supervises not only the retirement fund sector but also the insurance, collective investments and capital markets industries, and the intermediaries that market the products produced by these industries. In all financial services other than retirement funding, there is clear functional separation between product supplier and intermediary:

1.7.1. The product supplier -

1.7.1.1. must be financially sound (in the sense that it must be able to fulfil its promises); and

1.7.1.2. must produce products which are relatively standard, which can only change within contractual limits, and which must adhere to certain standards which are agreed with the regulator; while

1.7.2. the intermediary or retailer must ensure that he/she sells appropriate products to the consumer.

The product suppliers are largely “for profit” institutions, with shareholders whose capital is at risk, and the consumer buys those products on terms that may be negotiated with the supplier.

1.8. Retirement funds, on the other hand, are quite different: they are dynamic (in the sense that they may design and supply their own products and can change these from year to year), mandatory (in the sense that their members do not commonly join out of individual choice but because their contracts of employment require them to belong), non-profit organisations managed by boards appointed or elected by stakeholders. Benefit design and contribution rates may be negotiated between employer and employees, or trade unions acting on their behalf, and the actions taken by the board of the fund may impact upon labour relations between employer and employees. The board of a fund buys the services that are required “wholesale”, from a number of product suppliers and consultants who may be separately regulated and provides them to the members. The board undertakes functions which fulfil both a financial and social purpose. There are, therefore, labour, social welfare and financial issues involved.

1.9. In many jurisdictions these differences have been seen as requiring different kinds of regulation. It perhaps means that regulation of retirement funds should fall under the supervision of a separate regulator led by a board staffed by appointees able to reflect the views of various stakeholders in the retirement funding sector, including government, consumers, trade unions, business and service and product providers[41], without acting as representatives of anyone.[42] This body could then consult with formal representatives on an “arm’s length” basis, as and when required before making recommendations to the Minister.

1.10. There are criticisms that some regulation is not cost-effective and that the regulator does not always deal with the most important issues timeously. In order to address this, cost-benefit analyses should be performed for any new regulation, and the regulator should be obliged to adopt a risk-based approach to regulation.

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[41] Both the U.K. and Ireland have in recent legislation chosen to establish new retirement fund regulators separate from the single financial services regulator.

[42] There are different viewpoints here. One argument is that the body should comprise people who are actually representatives of constituencies within stakeholders in the retirement funding enterprise so that it can break deadlocks between those constituencies on particular issues. The other argument is that it will be virtually impossible to construct a body which would be truly representative of all stakeholders including unorganised groupings such as pensioners and non-unionised in-service members. The body should not seek to replace NEDLAC. Accordingly the body should be appointed by Government with due regard to the status of the various persons amongst “constituencies” of stakeholders so that the body is likely to be seen as legitimate. Nonetheless it should remain an organ of State, not a constituent assembly.

1.11. The National Treasury Task Team recommends that –

1.11.1. the Registrar of Pension Funds fall under the supervision of an appropriately constituted board which has the capacity to make decisions in the context of deadlocks between stakeholder constituencies and which is not subject to being overridden by other policy making boards or committees;

1.11.2. certain of the supervisory functions of the Registrar of Pension Funds be eliminated and replaced by the licensing of practitioners authorised to certify, for example, that the rules of a fund are not inconsistent with the Act, that a report on the actuarial valuation of a fund meets statutory requirements and/or that a scheme for the transfer of assets and liabilities from one fund to another is in compliance with the Act;

1.11.3. such licensed practitioners be given “whistle-blowing” rights and obligations, so that the Registrar may be timeously informed of breaches of the Act;

1.11.4. the Registrar of Pension Funds be authorised to approve transfers to and from retirement funds provided an appropriate process (required by statute or regulation) has been followed. Evidence of that process would be submitted in the form of certificates signed by the chairperson of the board, principal officer and actuary;

1.11.5. the Registrar of Pension Funds be given greater powers to enforce compliance including –

1.11.5.1. the power to conduct inspections into the affairs of retirement funds including inspections of the operations of service and product providers; consistent with the powers the Registrar now has in terms of the Inspection of Financial Institutions Act;

1.11.5.2. the power to act against trustees, service and product providers by fining, expelling, suspending and/or withdrawing such licenses as may have been issued to them;

1.11.6. the Registrar of Pension Funds be obliged to adopt a risk-based approach to regulation;

1.11.7. the Registrar also be obliged to promote education amongst members of occupational retirement funds to empower them to guard against possible abuse; and

1.11.8. the Registrar should be empowered to formulate codes of good practice which, although they would not have legal force, would have evidential value in proceedings before the proposed specialist retirement fund disputes tribunal (referred to in paragraph 4.4.1 below) or a court.

2. Statistical Reporting by Funds

2.1. Retirement funds registered in terms of the Act are required to supply certain prescribed information in their annual financial statements and triennial statutory valuation reports which must be submitted to the Registrar. The purpose of the submission of these documents is to enable the Registrar to identify funds that may be at risk of funding shortfalls or mismanagement so that he or she may take timeous action to correct the position.

2.2. It is currently difficult to adequately monitor trends that may require response in the form of legislative or regulatory intervention. Surveys that are done by private sector organisations are inadequate for this purpose. Accordingly, it is proposed that the regulator be empowered by board notice to require registered retirement funds to submit to him or her specified information, whether required on an *ad hoc* or a regular basis. The regulator will then be empowered to aggregate and publish this statistical information in a manner that will, if appropriate, ensure confidentiality for the providers of the information.

3. Member Protection

3.1. The protection of members can be viewed as taking four major forms:

3.1.1. The requirement that benefits be adequately pre-funded;

3.1.2. The protection of benefits when a member leaves the fund, particularly on transfer and liquidation; and

3.1.3. The prevention of the reduction of, and deductions from, benefits.

3.1.4. The disclosure to members on a regular basis of information regarding costs, contributions and benefits.

Funding is addressed in paragraph 8. Liquidation, specifically, is dealt with in paragraph 9.

3.2. In terms of the new provisions governing minimum benefits, members of funds registered in terms of the Act receive sufficient on leaving a fund after the end of a window period[43] to satisfy their reasonable

[43] The window period ends 12 months after the surplus apportionment date, which will be on or before the effective date of the statutory actuarial valuation after 7 December 2001.

expectations[44]. Section 37A of the Act also prevents the reduction of any benefit which has unconditionally accrued to a member, and section 37D protects members' retirement savings against cession and against claims by creditors of the members. Similar provisions appear in statutes in terms of which specific funds are established, such as the Transnet Pension Fund Act. The Pension Funds Act now also requires employers to fund shortfalls in the value of assets available to fund minimum benefits on the liquidation of funds to which they contribute. It limits the deductions that may be made from any benefit payable to a member to amounts in respect of tax, amounts awarded to the former spouse of the member, amounts due in terms of any housing loan or guarantee granted to the member, compensation due by the member to his or her employer for losses he or she caused it through acts of misconduct, and amounts payable to insurance companies or medical schemes with the consent of the member.

3.3. The National Treasury Task Team recommends that similar provisions be incorporated in the new statute, subject to the following:

3.3.1. the modification of the circumstances in which an employer will be liable to fund a shortfall in a defined benefit fund on its liquidation as discussed in paragraph 6.5.2 and

3.3.2. the elimination of the preferential treatment granted to employers as creditors of fund members.

3.4. The National Treasury Task Team further recommends that retirement funds be subject to more frequent and thorough disclosure requirements. On at least an annual basis, retirement funds should be required to provide information to each member regarding *inter alia*, the amount of contributions made on behalf of the member, the portion of the contributions that were used to pay administrative costs and the cost of risk benefits, the investment return of the fund (in the case of a defined contribution fund) and the total accrued retirement benefit of the member.

4. **Dispute Resolution**

4.1. Funds registered in terms of the Act are required to have rules providing for the internal resolution of disputes. However, those rules may not deny access to the Adjudicator.

4.2. The office of the Adjudicator was established in January 1998 and has had a dramatic impact upon the conduct of fund business in South Africa. The judgments of the Adjudicator have been published on the FSB's website

[44] In a defined contribution fund, this is the sum of their own contributions and the employer's contributions, less expenses, plus the nett investment return earned by the fund, as credited by the management board. In a defined benefit fund, this is sufficient which, if invested prudently until retirement age, will then have a value equal to the value of the benefit the member would have enjoyed from the fund in respect of service prior to date of exit.

and has allowed funds to derive some guidance from the Adjudicator's view of the conduct of other funds.

4.3. Unfortunately there are a multiplicity of *fora* which can adjudicate disputes concerning occupational retirement funding including the CCMA, bargaining council dispute resolution tribunals, the Labour Court, the Equality Court, the High Court, the tribunal of the Adjudicator, the appeal board established in terms of the Financial Services Board Act, special *ad hoc* tribunals established in terms of the Act to decide disputes concerning the apportionment of actuarial surpluses, the Ombudsman for Long-Term Insurance and the office of the Public Protector. This allows for "forum-shopping" and does not promote consistency and equal treatment.

4.4. The National Treasury Task Team recommends –

4.4.1. that there be established a specialist tribunal (which may be an extension of the current Adjudicator's office) to deal with all occupational and individual retirement funding disputes including -

4.4.1.1. disputes involving funds which are not now registered in terms of the Act, possibly including State funds and bargaining council funds;

4.4.1.2. disputes between fund members and those funds and/or their trustees;

4.4.1.3. disputes between funds and/or their trustees and the regulator;

4.4.1.4. disputes between funds (or fund members) and their service providers, even if the FAIS Ombud or any other statutory dispute resolution body usually has the jurisdiction to make a determination in such a case; and

4.4.1.5. disputes between fund members and their employers concerning the conduct of those employers in relation to the funds;

4.4.2. that there be a right of appeal against a determination by the tribunal to the High Court or the specialist FSB Appeal Board.

5. Governance and Trustee Conduct

5.1. Currently, members of retirement funds registered in terms of the Act, other than retirement annuity funds and umbrella funds, are entitled to elect at least 50% of the members of the funds' boards of trustees. Fund members in the United Kingdom (UK) have the right to elect only one third and those in the United States (US) are not entitled by statute to elect any. The right of members to elect trustees has had the effect of improving "democracy" in retirement funding but many trustees fail to appreciate that they owe their primary (fiduciary) duty to the fund as a whole and not to the "constituency" (employer, in-service members, union or pensioners) who appointed or elected them. In some instances, this has resulted in deadlocks between employer-appointed and member-elected trustees.

5.2. There are also deficiencies in the skills and expertise of some trustees, many of whom are responsible for the management of billions of rands of retirement fund assets. The standard by which the conduct of trustees is currently judged by our courts is the standard to be expected of a person in the position of the trustee in question, that is, with his or her level of education and expertise. This standard is probably not high enough, given the huge responsibility placed on the shoulders of trustees. The US statute (the Employee Retirement Income Security Act) requires trustees to act with the skill and prudence of persons familiar with the issues. This standard is about to be incorporated in legislation in the UK.

5.3. Boards of trustees are required to execute numerous duties, only some of which are set out in statute. The lower the level of expertise represented on the boards, the greater their dependence upon various consultants and other service-providers. There is no certainty in our law as to the nature of the duties owed by these service providers to the funds, and there are many instances in which trustees and/or service providers advance their own personal interests in breach of their duties to funds. In particular, many consultants have an interest in selling products or services (other than their advice) to the funds that they advise and so promote these products when other products or services might be more appropriate.

5.4. While it is arguable that the relatively high level of coverage by occupational retirement funds is attributable to the success of our retirement funding industry, the costs of the products and services sold by service providers in some instances have been disproportionately high in relation to their value. Sometimes these costs take the form of commissions or rebates paid by product providers to consultants or administrators who influenced the purchase of products by the retirement funds. These fees should be disclosed, particularly in terms of the Financial Advisory and Intermediary Services Act, but it is possible that some will not be or that such disclosure will be done in such a way as to minimise the chance of negotiation of the fee. For example, administrators are able to obtain lower asset management fees by "bulking" the assets of a number of funds into a single portfolio administered by the asset manager. Many do not pass on the savings to the funds or even disclose that the administrators or consultants are deriving financial benefit from the difference. The same is true of rates of interest granted by banks on the deposit of cash assets of funds.

5.5. The Financial Advisory and Intermediary Services Act will require consultants to demonstrate that their advice is appropriate but, if the trustees themselves are not knowledgeable and vigilant, they are unlikely to challenge the advice that they are given. If those fund consultants and other service providers to whom discretionary powers are granted by funds, or who, by the nature of their expertise, have the power to influence decisions by fund trustees, were by statute required to act in the best interests of funds, their conduct should improve and give the regulator and our courts greater powers to sanction those whose conduct is not consistent with this high standard. Just as decisions of boards of trustees have been subjected to the "rationality" test by the Adjudicator – that is, the test whether the decision bears a rational connection to the object to be achieved by it and is proportional to that object – so should be the conduct and remuneration and reward of fund service and product providers.

5.6. The National Treasury Task Team recommends that –

5.6.1. every fund be required to have a board of trustees;

5.6.2. members of funds be given the right to elect at least 50% of the members of the fund's board of trustees, unless the fund is exempted from this requirement for reasons which the Registrar considers in the best interests of members;

5.6.3. any fund which, with the permission of the regulator, does not grant to its members the right to elect at least 50% of the board of trustees, must have independent trustees approved by the Registrar as "fit and proper" comprising 50% of the board and 50% of any quorum required for trustee decision-making. These trustees, if paid, must be paid for their services by the funds alone and must have no financial interest or employment relationship with the fund sponsors or participating employers. They must be given special "whistle-blowing" obligations and protection from victimisation when they fulfil those obligations;

5.6.4. the statute state that trustees of funds owe a fiduciary duty to their funds and a duty of good faith to all stakeholders;

5.6.5. there be a codification of the main common law duties of trustees, including the duty to protect the rights of members in relation to benefits arising as a result of past service and the duty to disclose to members such information as they may reasonably require to make appropriate choices and to protect their rights;

5.6.6. trustees may not amend the rules of a fund in such a way as to reduce the current capital value of members' unconditionally accrued retirement savings attributable to service to date, unless this would be necessary to ensure that the fund remains financially sound and a majority of the members of the fund have indicated in writing that they would prefer the reduction in their benefits to the liquidation of the fund;

5.6.7. trustees may not seek to advance the interests of one group of stakeholders at the expense of another without their written agreement. If an employer and its employees agree on a rule amendment, the trustees should enact it provided that it is not inconsistent with compliance with any law;

5.6.8. trustees are obliged to take such steps as may reasonably be required to avoid conflicts between their personal interests and their duties to their funds including –

5.6.8.1. declaring in writing their interests in any decision in which they may have a direct or indirect personal interest – other than their interest as a member of the fund; and

5.6.8.2. refraining from participating in any such decision; unless this would be impracticable because their interest is as members of the fund;

5.6.9. the standard by which trustee conduct (including trustee decisions) is to be judged is the standard of a person who is familiar with the issues under consideration by the trustees;

5.6.10. trustees who lack appropriate expertise must undergo training at the expense of their funds to obtain such expertise or seek the advice of appropriate experts;

5.6.11. each actual or intended provider of a service or product to a fund and each representative of such provider will be obliged to disclose any interest in any service or product which is being promoted to the fund, and to refrain from taking any part in any decision by the fund in relation to itself;

5.6.12. providers of services to funds are required to set out in writing to the funds their advice on material matters and the reasons for their advice;

5.6.13. any provider of a product or service to a fund to whom discretionary power is granted by a fund or who has the power to make or influence a decision of a fund, must act in the best interests of the fund;

5.6.14. each provider of a product or service –

5.6.14.1. must be prohibited from accepting any remuneration or other reward from any person other than the fund as a consequence of the purchase by the fund of a product or service from that person or any person related to it;

or alternatively

5.6.14.2. must disclose in writing the estimated or actual rand value of each actual or potential reward that they or their employer will enjoy as a consequence of the purchase of a product or service by the fund on the advice of the provider, and why he or she believes that the reward is appropriate when regard is had to the value of the provider's advice;

5.6.15. each service or product provider which is requested to provide a quotation in respect of services or products must, if it proposes to pay any commission or other reward to any person as a reward for facilitating the purchase by the fund of the product or service, disclose the rand value of that commission or other reward and the price at which the service or product would be sold to the fund if no commission or other reward were to be paid;

5.6.16. the regulator has the power -

5.6.16.1. after consulting interested parties, to formulate codes of good practice for trustees, including codes relating to the assessment of the performance of the trustees;

5.6.16.2. after due process, to fine, suspend or disqualify and, pending the appointment or election of a replacement, replace a trustee who does not fulfil his or her duties to the fund or comply with such codes of good practice as have been given statutory force;

5.6.16.3. after due process, to fine, suspend and/or withdraw the license of any service or product provider who or which does not comply with his or her or its obligations in the statute;

5.6.16.4. to determine guidelines as to the amount of fidelity cover which it would be appropriate for a fund to maintain;

5.6.17. trustees must –

5.6.17.1. be given reasonable paid time off work to attend to trustee work, including trustee training;

5.6.17.2. not be victimised by employers if they take decisions which are not in their employers' best interests; and

5.6.17.3. hold annual general meetings of the members of their funds unless exempted from this requirement by the regulator for reasons which the regulator regards as sufficient;

5.6.18. that trustees ***may*** be paid for their services[45] but only by their funds and they may not accept substantial gifts or rewards of any kind from any persons or bodies other than their funds which relate to their occupation of the post of trustee;

5.6.19. the rules of a fund must specify the maximum proportions in which contributions made to a fund will be allocated to retirement funding, administration and investment costs and risk benefit costs including risk benefit premiums;

5.6.20. umbrella or multi-employer funds should be subject to specific provisions including –

5.6.20.1. a requirement that the fund's auditor report annually on the adequacy of systems and controls employed by the fund;

5.6.20.2. a limit on the number of fund which can form part of one umbrella fund;

5.6.20.3. a requirement that there be separate annual financial statements for each sub-fund and a prohibition on cross-subsidisation between sub-funds;

5.6.20.4. a requirement that the fund's administrator maintain adequate fidelity cover;

5.6.20.5. a requirement that an independent person report annually on the adequacy of the fund's communication with its members;

5.6.20.6. a provision stating that any fund rule which purports to make use of a specified service provider compulsory, be of no force or effect;

5.6.21. retirement funds, membership of which is by individual choice, must –

5.6.21.1. give members a "cooling off" period after joining during which they may elect to withdraw their

[45] This proposal is consistent with that made in the *Myners' Report*, which reviewed institutional investments in the UK. It is consistent with trying to increase professionalism amongst trustees. If fund members do not believe that their trustees should be paid, they should vote out those they can and complain to the retirement fund complaints tribunal about the others. It is merely a proposal to empower, *not* to make remuneration compulsory. Consideration could also be given to limiting payment to certain classes of trustee (eg. pensioner or independent trustees).

membership without charge (and with full refund of any moneys paid to the fund); and

5.6.21.2. permit members to have their retirement savings transferred to other funds of their choice without financial penalty and after disclosure of the costs of such transfer – which may be limited by legislation.

6. Intersection of Labour Law and Pensions Law

6.1. The earliest occupational retirement funding arrangements were operated as schemes within employers' books: In essence the employers promised to pay certain benefits (usually pensions) to those employees who worked for them for a large part of their careers and retired from that employment. It was then deemed desirable to pre-fund these liabilities in vehicles legally separate from the employers and so pension trusts were established. These trusts were, however, under employer control. Employers were able to appoint trustees, manage the investment strategy of funds and enjoy the benefit of withdrawal profits when those employees who left before retirement forfeited claims to employer contributions and interest.

6.2. Since 1956, retirement funding business has had to be conducted through retirement funds either established by statute or collective agreement in a bargaining council or registered in terms of the Act. These funds are independent legal entities and their trustees are required to act in the best interests of the funds themselves, rather than in the interests of their sponsors, the participating employers. Since 1998, members of funds registered in terms of the Act have been entitled to elect at least 50% of their trustees and the minimum benefits and surplus apportionment provisions incorporated in the Act by amendment in December 2001, have dramatically improved the financial security of members, reduced employer control and have increased employer risks of liability, particularly on the liquidation of funds. Employers now face the risk that they will have to fund shortfalls in funds in liquidation over which they had little control and which were mismanaged or the victims of crime.

6.3. Despite the changes to legislation which have ensured a more "arm's length" relationship between employers and the retirement funds to which they contribute, there remains significant uncertainty in employment law as to what an employer's obligations are in relation to retirement funding. This uncertainty represents a significant risk to employers, most particularly in the context of transfers of business when employees become entitled to be employed by the purchasers of those businesses on the same terms and conditions of employment as previously applied. If the seller in a particular case contributed to a defined benefit fund, it may be very difficult and financially extremely onerous for the purchaser to attempt to reproduce the same retirement funding regime.

6.4. It is furthermore by no means clear that employees are entitled to identical retirement fund benefits. It may be that all that they are entitled to are contributions by the new employer to a retirement fund at the rate at which those contributions were made to the employees' previous funding, or only the preservation of their retirement savings "accrued" in their funds to date because there is never any certainty that a particular employee will remain in employment until retirement, or become entitled to retrenchment or disability benefits.

6.5. In the context of the new minimum benefit provisions of the Act, the National Treasury Task Team recommends that it be made clear in legislation that the "pension promise" made by an employer to a member of a defined benefit fund[46] is one which indicates that -

6.5.1. an employer is entitled to procure the conversion of a defined benefit fund to a defined contribution fund, or to procure the transfer of its employees from a defined benefit fund to a defined contribution fund, whether in the context of a transfer of employment or not, without the consent of the employees (but after fully informing them of the proposed conversion) provided that –

6.5.1.1. the opening fund credit of each affected member in the converted fund or in the new fund will be not less than the value of the member's minimum individual reserve in the pre-conversion fund or the old fund, as the case may be; and

6.5.1.2. the employer will make such contributions to the retirement fund or another one for the benefit of the employee which, together with the retirement savings earned to date, contributions payable by the employee and expected return on the investment of those amounts (assumptions in relation to each of which may be prescribed by the regulator) less investment expenses and assuming that the member remains a member of the fund until retirement, can reasonably be expected to procure for the employee a retirement benefit equivalent in value to the benefit to which the employee would have been entitled on retirement in terms of the old defined benefit rules of his or her original fund;

6.5.2. On the liquidation of an under-funded defined benefit fund – and provided that members of the fund are treated as preferred creditors - the employer must fund any shortfall in the assets available to fund their minimum benefits as defined by statute unless -

[46] The issue is only significant in relation to defined benefit funds.

6.5.2.1. the shortfall was attributable to a material breach by the fund's trustees or service providers or other of their duties to the fund; or

6.5.2.2. the financial burden on the employer would be so great as to compel it to retrench staff or be liquidated itself, in which case the board of the fund may agree to payment of a lesser amount by the employer, with approval from the regulator.

6.5.3. A fund's liabilities in respect of its pensioners must be pre-funded with appropriate assets allocated to a pensioner account for this purpose on the retirement of a member. Thereafter the pensioner's erstwhile employer should have no decision-making power or exposure to risk in relation to the application of those assets in the funding of pensions and pension increases. The obligation of the employer towards the pensioner will be limited to the outstanding contributions, if any, in terms of any funding plan to meet any shortfall between the assets transferred into the pensioner account and the value of the pensioner liabilities on commencement of retirement, or on transfer of a group of pensioners into the fund.

6.6. The law should also state that changes to fund rules which could have the effect of reducing the minimum benefits payable by the fund, are only permissible after the exercise by employers and employees of their rights and obligations in employment law in relation to changes to conditions of service.

6.7. This should allow employers to restructure their operations and liabilities without undue financial burden and provide appropriate protection for employees affected by such restructuring.

7. Investment Regulation

7.1. Investments by retirement funds registered in terms of the Act are, as per regulation 28, subject to prescribed limits as to the maximum percentage of the assets of a fund which may be invested in a particular asset class. These limits are designed to achieve diversification but fail to guide retirement fund trustees as to what investment strategy would be appropriate when regard is had to the specific nature and obligations of their fund. The limits also encourage a "herd" mentality amongst asset managers and prevent funds from making what may be appropriate investments in, for example, structured products. The investment limits, furthermore, do not apply to insurance policies which include any form of guarantee and so one of the principal purposes of the investment regulations is undermined.

7.2. Shareholder activism by South African retirement funds is still in its infancy and should be encouraged. A US Department of Labour Interpretative Bulletin informs fund trustees that they are required to exercise the votes attaching to shares owned by their funds[47] if they are to properly fulfil their fiduciary duties. The *Myners Report* recommends that this interpretation of the common law duties of trustees be reflected in UK legislation.

7.3. Fund trustees and asset managers have a tendency to take too short-term a view of investments and avoid making what are known as "socially desirable investments" unless they are of the least controversial kind; the kind that entails screening for good corporate governance, sound labour relations, environmental friendliness and so forth. They appear not to appreciate that, unless there are fundamental changes to our economy, such as significant increases in employment, all retirement income is at risk. While fund trustees are not expected to make investments that will not result in a real return, a measure of social investment by funds is appropriate and can contribute to our financial security and economic growth.

7.4. A significant number of funds have granted to their members "member investment choice". This means that members are invited to select the portfolios in which their retirement savings are to be invested, regardless of whether they have the appropriate expertise for the purpose. Some funds offer expert assistance. Sometimes such assistance is available only to the higher-income members. Experience has shown that most members are more conservative in their individual choice than the board of the fund would have been if they had been making the choice on behalf of members. This is likely in the long run to adversely affect the adequacy of these members' retirement benefits. On the other hand, where members have appropriate expertise, "member investment choice" can enable individuals to tailor their investment choice to their particular risk profile and age, enhancing the adequacy of their retirement benefits. Member investment choice entails additional cost and its introduction may be motivated more by those with a financial interest in expanding the services they offer to the funds than by those with members' interests at heart.

7.5. The National Treasury Task Team recommends the incorporation into legislation of the principles reflected in the draft new regulation 28 of the Act, amended to eliminate problems already identified with it. In particular, the Task Team recommends the adoption of a combination of the "prudent expert" measure and certain quantitative measures. This would require that –

[47] Particularly where those votes may enhance the independence of the board of directors of a company, and ensure that the board of directors gets sufficient information to enable them to supervise the performance of executive management.

7.5.1. *maxima* be set by the regulator for fund investments in participating employers[48], any single investment and investments outside the RSA;

7.5.2. there be no prohibitions on investments in any particular asset class;

7.5.3. these provisions apply to both direct investments and investments through insurance policies;

7.5.4. standard prudential limits be set for the various asset classes for those funds the boards of trustees of which are unable to devise and implement an investment strategy as set out below, usually because the size of the fund does not justify the expense involved;

7.5.5. a fund that, after taking expert advice, adopts a properly formulated investment strategy that is certified by the fund's valuator to be appropriate after taking account of its specific nature and obligations, may apply to the regulator for exemption from the standard quantitative limits on condition that the fund adopts that investment strategy, informs the fund's members of it, implements the strategy, monitors compliance with the strategy, reviews the strategy at least once a year and reports to the regulator from time to time on its compliance with these conditions.

7.6. In addition, the National Treasury Task Team recommends that –

7.6.1. the regulator be required to suggest benchmarks against which the performance of asset managers may be assessed from time to time;

7.6.2. trustees be required to regularly monitor and measure the performance of asset managers against such benchmarks as may be suggested by the regulator or any other appropriately qualified person;

7.6.3. funds be required to state in writing in a document to be distributed to their members and participating employers whether they intend to invest any part of the assets of the fund in socially desirable investments which are likely to yield returns

[48] For example, the Enron pension fund invested all of its assets in Enron so its members lost not only their jobs but their retirement savings too when Enron collapsed. Our existing regulation 28 limits fund investments in participating employers to 5% of the value of the fund's assets or, with the permission of the Registrar, 10%.

lower than those which may be expected of other investments by the fund[49];

7.6.4. funds be permitted to invest up to 10% of their assets (by value) in such investments through collective investment or private equity schemes provided that it can reasonably be expected that such investment will yield a return of not less than the increase in the rate of inflation over the period of investment;

7.6.5. trustees be prohibited from granting investment choice to members unless –

7.6.5.1. the portfolios in which the members are invited to invest are selected because they reflect investment strategies consistent with those that the trustees feel appropriate when regard is had to the likely profile of those members and the investment risks to which they will be exposed;

7.6.5.2. the investment strategies employed with respect to each portfolio (including the concomitant risks) are explained to members;

7.6.5.3. a default option is granted to members, and there are a limited number of options from which to choose[50]; and

7.6.5.4. the trustees monitor the performance of each investment portfolio against criteria determined in the context of the fund's investment strategy and remove investment options whose performance or conduct is not consistent with those criteria.[51]

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[49] Modern portfolio theory requires that the performance of a portfolio should be assessed as a whole. Funds should have a mix of investments, some of which may not be high yielding in the short term but which may assist in stabilising our economy in the long run. That role may be as important to protecting the security of retirement savings as is the role of high yielding investments. As long as an SRI investment is sound, that is, it will retain the real capital value of the investment, and SRI investments of this nature by a single fund do not exceed, say, 10% of its assets, then it can make for a prudent fund investment.

[50] Research has indicated that too many options cause member confusion, and increase the probability that members will simply opt for the default portfolio. National Treasury therefore suggests a limit of, say 3 or 5.

[51] Funds with member investment choice will have to be given time to phase in compliance or phase out member investment choice. These recommendations already appear in the draft regulation 28 and have a sound basis in law. Trustees in law will be guilty of an improper delegation of their responsibilities if they delegate investment decision-making responsibilities to anyone other than someone appropriately qualified for the job.

8. Funding and Calculation Techniques

8.1. Retirement funds which are registered in terms of the Act are required to be fully funded and, if they are under-funded, to formulate and implement plans to become fully funded within a reasonable period of time. The funding levels of these funds, other than funds exempted from this requirement, are monitored by the Registrar of Pension Funds to whom reports on the triennial actuarial valuation of the funds must be submitted. The Registrar is empowered to reject any report that, in his or her opinion, does not properly reflect the financial condition of a fund. The required funding standards are high. In particular, funds which require actuarial valuation are valued on a projected benefit obligation basis: that is, the actuarial value of the fund's assets is measured against the value of the fund's liabilities in respect of past service, taking into account future salary increases projected up to normal retirement age and pension increases projected thereafter. The assumptions used in valuations are required to be "best estimate" assumptions modified for any long-term trends identified by the valuator. These assumptions must be stated in sufficient detail to enable an independent actuary to assess the adequacy of the valuation report. A fund valuator is required to state whether, in his or her opinion, the assets of the fund being valued are appropriate in relation to the liabilities of the fund. There is an increasing use amongst, in particular, large funds, of asset-liability modelling techniques to assist in the formulation of investment strategies. These are all appropriate measures and should be continued.

8.2. Provision must be made in funds for the minimum benefits which have become payable by these funds. Actuarial surpluses as at the effective dates of the first statutory valuations of retirement funds after 7 December 2001 must be equitably apportioned amongst stakeholders. Surplus assets may only be paid to participating employers upon the liquidation of the fund or if it is required to avoid retrenchments by the employer. Minimum pension increases must be set having regard to the nett investment performance on the assets backing pensioner liabilities.

8.3. In many other jurisdictions, funding standards incorporate a deliberate level of conservatism applied to realistic assumptions in what is described as a "solvency valuation". No such standard has been set in South Africa.

8.4. The National Treasury Task Team recommends that –

8.4.1. where appropriate, every fund must be actuarially valued at least once every three years in order to determine the contribution rates, the adequacy of any contingency reserve accounts and the level of actuarial surplus, using realistic assumptions which are amended to incorporate a reasonable level of conservatism, along lines agreed between the regulator and the actuarial review committee. [52]

8.4.2. if a fund has pensioners, and the pensioner liabilities are not underwritten by an insurer, the assets that back the pensioner liabilities must be held in a separate pensioner account. Both those assets and the corresponding pensioner liabilities must be actuarially valued every year before a pension increase may be determined, to ensure that the fund can afford the increase granted, and to take account of minimum pension increase provisions;

8.4.3. the regulator be obliged to establish an actuarial review committee comprising, amongst others, experts nominated by stakeholder groups, and which would be tasked with –

8.4.3.1. determining the standards with which fund valuators would be required to comply, including a requirement that any fund which self-insures death and disability risks maintains a prudent level of contingency reserve assets consistent with the capital requirements of a long-term insurer;

8.4.3.2. reviewing methods and assumptions used in particular cases at the request of the regulator; and

8.4.3.3. at the request of a valuator, providing guidance on, and approval for, the use of particular methods and assumptions in relation to the valuation of a particular fund;

8.4.4. provisions in the current Act relating to the treatment of actuarial surpluses be maintained; and

8.4.5. there be a modification of the circumstances in which an employer will be required to fund any shortfall in a fund upon its liquidation as contemplated in paragraph 6.5.2 above.

9. Winding Up

9.1. The current Act contains provisions designed to protect members upon the winding up of a fund. These include the requirement that the minimum benefits of members be provided for, failing which the shortfall must be funded by any remaining participating employers. Unfortunately this protection is not extended to a fund on its partial liquidation – that is, when

[52] An actuarial valuation is not necessary for a pure defined contribution fund, as it cannot go into deficit. However an annual comparison of assets and liabilities and an assessment whether the contribution rates are adequate, by a suitably qualified person is advisable and good governance.

a substantial number of members are transferred out of the fund. Furthermore, those measures are ineffective when the assets and liabilities of a fund are transferred to another fund and the fund does not undergo formal liquidation proceedings. In those circumstances the fund is simply deregistered. Furthermore, members of funds which are formally wound up are treated as deferred creditors. This means that, if the fund is unable to compel an employer to fund any shortfall in the assets available to fund their minimum benefits, they will suffer a loss but the fund's other creditors – largely its service providers – will be fully provided for.

9.2. South Africa does not have an insurance scheme designed to fund shortfalls in funds upon their winding up. Such a scheme has been resisted by stakeholders in the retirement funding sector on the basis that it would compel well-managed funds to subsidise the less well managed. In a number of other jurisdictions, such an insurance scheme exists[53] or is being established[54], because investment losses have occurred prior to the winding up of funds which are then in a deficit situation.

9.3. The National Treasury Task Team recommends that –

9.3.1. the new statute include provisions that enable the efficient and inexpensive partial or total winding up of retirement funds and the extension of the protection of such provisions to circumstances in which the assets of the fund are depleted by, for example, their transfer to another fund;

9.3.2. a task force should review the desirability of a pension guarantee scheme to protect members of those funds which are wound up in circumstances of insolvency.

9.3.3. If it is decided not to proceed with a pension guarantee scheme, instead –

9.3.3.1. retirement funds be required to maintain adequate fidelity insurance and professional indemnity cover; and

9.3.3.2. strong funding requirements be maintained to minimise the risk of insolvency of funds on their winding up.

[53] The United States of America

[54] The United Kingdom

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