Response to the National Treasury Retirement Fund Forum discussion paper

I am a South African actuary currently living in Australia, who has long had an interest in retirement matters. I have, *inter alia,* served on the Pensions Committee of the Actuarial Society of South Africa, the Ministerial Advisory Committee on Pension Funds, National Retirement Consultative Forum (NRCF) committees, the Taylor Committee where I was Convener of the Old age and Retirement subcommittee and am the author of the chapter on "Pensions in Africa" for the soon to be published Oxford Handbook on Pensions.

In making submissions of this nature, I believe that it is appropriate to disclose one's personal interests. My current employer is the Australian Prudential Regulation Authority, but it is possible that I will in future earn some remuneration from South African financial institutions. Almost all my retirement savings remain in South African retirement funds, and I remain interested in the health of the industry.

My comments are made in the context of my personal delight that retirement fund legislation is being holistically reviewed, and believe that the discussion paper represents the right direction and provides a useful agenda for desirable policy changes. Rather than respond to every point, I would like to make some comments where I try to speak for those who are more likely to be voiceless in this debate.

Means Test

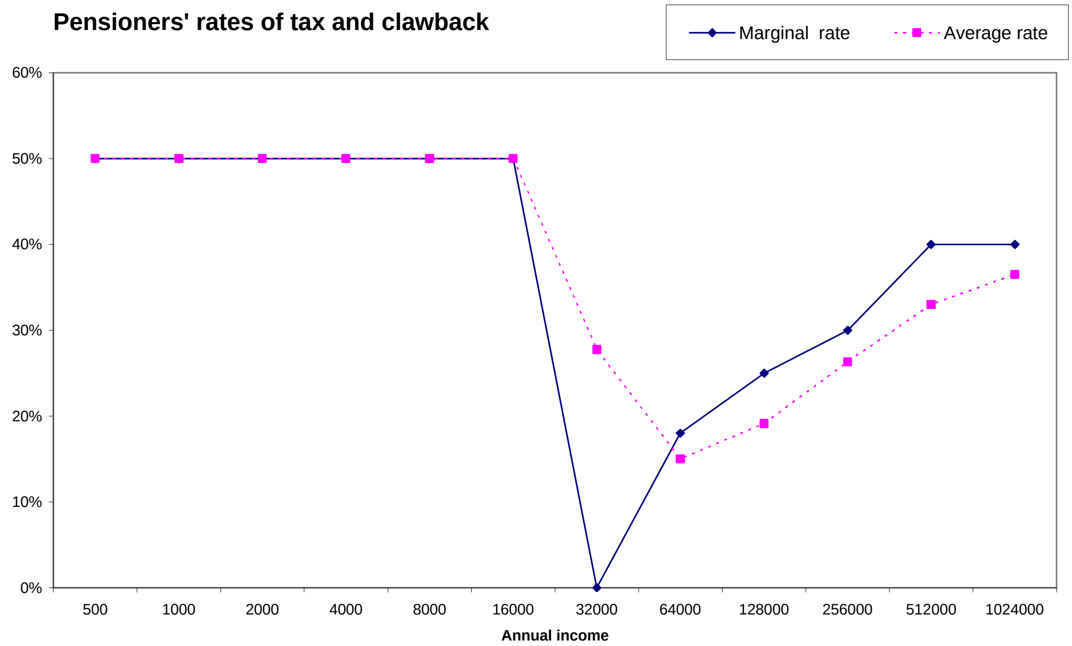
Means tests are costly, ineffective and socially disruptive.

They are practically impossible to administer efficiently. This is because they require over-worked and non-financially trained employees of the Department of Social Development to make detailed evaluations of small amounts of income that are likely to come from a variety of sources – formal and informal. Employees of the South African Revenue Service, better resourced and specially trained financial specialists, can find it difficult to trace much larger amounts of money.

They are inequitable as they apply a higher rate of "tax" to poorer people, and cannot take non-cash incomes into account. They also act as a poverty trap encouraging poor people not to provide for themselves.

Over the last dozen years, I have made representations to this effect to the Katz Committee on retirement fund tax, to the Smith Committee, in the NRCF general forum and in the steering committee, and in the sub-committees of the Taylor Committee. I have yet to meet anyone who has attempted to defend them in any meaningful fashion. Most recently, members of the Taylor Committee were unanimous in recommending that they be abolished – as a means of rationing social security benefits. It is telling that there were no representations to the committee suggesting that the means tests were redeemable if reformed.

I am conscious that abolishing the means tests would mean making payments to wealthier people. Such payments are however dwarfed by the tax concessions that they currently enjoy through the deductibility of retirement fund contributions, low rates of tax on retirement fund investment income[1], tax free retirement fund benefits and the special tax rebates for pensioners on their taxable income and interest earnings. These concessions benefit pensioners earning over R32 000 annually, who face a maximum tax rate of 40%. The means test on the other hand penalises those earning as little as R500 annually of this at a rate of 50%. This is illustrated in the graph below.



It is monstrous – if I might be forgiven the excessive language. I urge the National Treasury and the government to have the courage to abolish the means tests (and some of these concessions) in the face of the opposition they will face from the retirement fund industry and wealthier pensioners. Those who suffer under the burden of the means tests are unlikely to be heard, but they are needier and more deserving.

National Savings Fund (NSF)

As I see it, the purpose of the NSF would be to offer a long term savings mechanism to those on low and irregular incomes who currently do not have access to low cost group retirement funds. The main issues as I see them are in the design, that should not penalise "non-payment", and in accessibility in terms of knowing where to go to make contributions.

It can perhaps be noted that those contributing to formal sector "regular premium" savings contracts are not only penalised by the life insurers and retirement annuity funds when they fail to pay contributions, but also by banks when debit orders are returned unpaid. The Taylor committee was given bank accounts that showed state

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[1] It is true that a higher tax on investment income would penalize lower income individuals, but it should be noted that it is precisely these people who currently suffer under the means test. The gains and losses from different tax and means tests should be seen holistically. Those who argue for lower rates of investment earnings are invariably major beneficiaries of the concessions.

pensioners had lost hundreds of rands in wasted contributions and debit order penalties.

While there may be arguments for a small subsidy to the NSF to keep charges low, it does not seem to me that the NSF investment returns should be subsidised – either directly or by giving particular tax or means test exemptions. Such exemptions will inevitably benefit wealthier people, who need no special help at this time.

The NSF could collect contributions through Post Office branches. Greater marketing success may however be achieved by private sector distributors. If so, I would suggest limitations on the bank and administrative charges along the lines of the "stakeholder pensions" in the UK.[2]

Individual choice

The National Treasury Task Team appears to be somewhat influenced by Australian developments in suggesting that employees be offered a choice of retirement funds, and individuals be permitted to set up individual retirement funds. Legislation offering choice will only come into operation in July of this year, and I would strongly recommend that the Australian experiment be observed in greater detail before its introduction to South Africa. It should be noted that British experiment in choice was extremely expensive, and that those that have followed the Chilean model on choice have experienced much higher cost levels without any apparent benefits over the current South African model.

It seems to me that much of the success of the South African retirement system can be ascribed to financial regulations, industrial policy and industry practice that has made most South Africans in formal employment members of employment based fund. While compulsory membership of such funds is a limitation on freedom, there are significant benefits in terms of lower charges, freedom from retail marketing costs, the possibility of underwriting free cover, and influence over the governance of the companies in which the funds are invested. I believe these aspects of the South African system are worth preserving.

Target benefits

One of my special actuarial interests is the modelling of people's financial life cycle. My research suggests that the 75% target mentioned in Annexure 3 may be excessive, and my experience with the retirement industry suggests that it will be used as an authoritative target to urge people to save more than they need.

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[2] It is often said that stakeholder pensions have been a failure, but a recent press release indicates that 2,3 million have been sold in the past four years. Given the initial target market of 5 million low income individuals, this seems to me to be a considerable success for a new product. See http://www.dwp.gov.uk/mediacentre/pressreleases/2005/mar/lifestyling140305.asp

If we focus only on those whose income over their life time is adequate, and who face no significant reductions in their incomes just before retirement:

- Basic living costs can be determined partly on a per capita basis. If a couple starting work have life expectancy of 60 years each and they pay for the costs of 3 children over 20 years each, their combined income has to cover 180 person years, of which the children account for a third. These numbers thus suggest a first approximation of 66% as a target for the lowest liveable incomes. Adjustments can be made for single parents or more children (as is the case for many poorer people), and economies of scale.
- A house will cost some 10% of a lifetime's earnings to buy, so reduces the percentage by 10%.
- The contribution rate to save for retirement over a forty year lifespan will be of the order of 10% to cover insurance and charges, so reduces the target by another 10%.
- If a significant contribution has been made for the children's education – school fees and university – then the amount can be further reduced. (In my own case, I will probably have spent 15% of my lifetime's earnings on educating my 3 children).
- All taxpayers will face a lower rate of tax after retirement.

Even if 75% is appropriate for those on reasonable but low incomes, higher income earners may well find themselves as well off in retirement on gross replacement ratios of half that level.

Administrative issues

There are a few administrative issues that particularly effect lay trustees (unpaid non-specialists) where I feel commercial service providers are less concerned – or have other interests.

- In terms of the role of the management board in deciding how to allocate benefits (paragraph 3.18.1 on page 46), I would note that such decisions can take up a significant proportion of the time of a board. I would suggest that this is an inappropriate use of their time which should be focussed on strategic issues rather than administrative details, and there should be express regulations for them to delegate their responsibilities to some appropriately qualified person. The fund should moreover be protected from claims for damages – within reasonable bounds.
- I would strongly urge that funds be permitted to offer temporary disability benefits. (paragraph 3.19.3.1 – page 48) It will be easier for people to obtain cover; there are savings in administrative and marketing costs and it is in many ways fairer – those who receive disability benefits are likely to benefit less from a pension as they will die earlier. It would also be inconsistent to allow some payments on unemployment and not on temporary disability – as these two conditions are often related. Restrictions on the percentage of the fund used to pay such benefits would be acceptable.
- My preference would be to prohibit service providers receiving any remuneration except from the fund. (paragraph 5.6.14.1 – page 48) My experience has been that this suggestion has been vociferously opposed by

many participants in the market. This has confirmed my impression that the issue is an important one. My experience is that professional and expert service providers find it all too easy to persuade relatively inexperienced trustees that the commissions payable are “normal business practice.” The ability of the New York Attorney General to extract significant fines out of insurers and banks for analogous commissions indicates that apparently reputable financial institutions are capable of illegal conflicts of interest. Disclosure, however complete, does not make it clear to trustees that they have the power to decide on the extent of the remuneration.

- I would suggest that the requirement to hold contingency reserves (paragraph 8.4.3) is inappropriate. Self insurance without reserves is acceptable if the members understand the size of the risk and it is not unreasonable relative to the investment risks they are already taking. Funds should take however out insurance to cover catastrophes.

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