RETIREMENT FUND REFORM
(Discussion paper)

Submission in respect of Annexure 3 Clause 3.18 of the Retirement Fund Reform discussion paper

PAYMENT OF BENEFITS ON DEATH

Introduction

This submission is made with particular reference to Clause 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."*

and

Clause 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."*

This submission deals primarily with the issue of disposal of death benefits in the case of minor dependants or nominees, and dependants or nominees with a legal disability.

Although the discussion paper supports the payment of a death benefit by way of an income, there appears to be a limited appreciation of the historical development and relative merits of the mechanisms available for dealing with the administration of death benefits. The pros and cons of these mechanisms are discussed in the section below.

Indeed, it is as a result of problems in this area that umbrella trusts evolved in the late 1980s in response to the amendment of section 37C of the Pension Funds Act, whereby death and disability benefit payments could be legally settled in trust for the benefit of dependants of retirement funds. Since then, we have seen the trust industry develop from a relatively unsophisticated into a highly professional and value-add service.

Definition: An umbrella trust is defined as a trust that is registered with the Master of the High Court whereunder sub-accounts can be established for each beneficiary. Each beneficiary is then registered with the South African Revenue Services for tax purposes, although the amounts in question mean that in nearly all cases they would fall outside the tax net.

The umbrella trust industry is a well-established, effective service used by most retirement funds and all leading retirement fund administrators in South Africa. It is estimated that the market value of umbrella trusts managed by the leading trust companies exceeds R10 billion, with annual growth exceeding R1 billion, and currently representing in excess of 350 000 beneficiaries.

The growth of the umbrella trust industry has been predominantly driven by the increased value of benefit payments as a result of improved benefit structures, and an increase in the number of deaths arising from the HIV/Aids pandemic. It is likely that the trend will continue for the foreseeable future, as shown by statistics presented by consulting actuary Roseanne da Silva at the conference of the Institute of Retirement Funds in September 2004.

Da Silva estimated that current average levels of HIV prevalence in the South African workforce are around 20%. While HIV prevalence is expected to peak in 2007, Aids deaths are set to peak only in 2009. Widespread access to antiretroviral therapy will help defer some of these deaths, but they will not be prevented.

Current options for the disposal of death benefits

In disposing of death and disability benefits, trustees of retirement funds have a fiduciary responsibility to ensure that the best alternative is selected to suit the needs of the dependants. The options currently open to them include the following:

a) *Pay the benefit direct to the dependant*

Where a dependant is a major, in most cases the benefit would be paid over direct to him or her. There are two provisos: if the major dependant has a legal disability (i.e. is under curatorship, or mentally handicapped); or if the major dependant consents, then the benefit can be administered in trust or within the fund.

b) *Pay the benefit to the legal guardian of the dependant*

In the case of a minor dependant, a benefit payment can be made to the guardian. This may be a practical option, particularly where the benefit payment is relatively small. There are a number of potential problems, however, such as:

? Determining the correct legal guardian.
? The guardian may not be competent to manage the funds or able to select the appropriate investment vehicles for the funds to be maximally effective for the beneficiary. It is also difficult for retirement fund trustees to determine the competency of guardians.
? The guardian may misuse the funds, possibly for self benefit.
? Trustees expose themselves to possible subsequent litigation from a dependant for paying a benefit to an incompetent guardian.

In the event of the guardian's death, unless the benefit is held in a separate account by the guardian, it will be treated as part of the guardian's estate, which creates administrative and legal problems.

c) *Administer the benefit within the retirement fund*

Retention of a benefit payment within a fund is a viable option, particularly where the dependant is about to attain the age of majority. Again, however, there are a number of pitfalls, such as:

? Retirement funds do not generally have the administrative infrastructure.
? If this service is not properly costed, existing members of the retirement fund tend to cross-subsidise the service.
? Dependants' needs are generally not met as a result of poor service and inappropriate investment strategy.
? Past experience of this practice has lead to extensive administrative problems.
? This practice may be tax inefficient.

d) Pay the benefit over to the Guardians Fund under the Master of the High Court's management

Funds awarded to the Guardians Fund result in poor investment returns, inadequate service and limited access to funds. This is not a responsible option for trustees of retirement funds. It is a well-known fact that the Master has major resource constraints.

e) Pay the benefit into an umbrella trust

Awarding funds to an umbrella trust managed by a trust company in most cases is the optimal solution, for the following reasons:-

? Trust companies are specialists in trust services, and have the administrative platform to properly manage benefit payments.
? Funds are legally held in trust (a separate legal entity) where it is the responsibility of the trustees of the umbrella trust to ensure that the dependants' interests are protected.
? Trusts offer enormous flexibility with regard to capital requirements and have the ability to generate monthly income to suit the beneficiaries' needs.
? The needs of individual dependants are addressed through personalised service and tailored individual investment strategies.
? The legal responsibility no longer vests in the trustees of the retirement fund, but rather in the trustees of the umbrella trust.
? Institutional investment returns are achieved as a result of the bulking of funds.
? Costs are competitive, when compared to the alternatives, such as other income-generating investments that may not provide for capital withdrawals, in particular for educational expenses.
? Dependants receive personalised advice from the trust administrators whose sole focus is the well-being of these dependants. The advice is received from reputable service providers who are FAIS-compliant.

The above discussion highlights the historical reasons for which the umbrella trust industry has grown over the past 20 years. The following part of our submission relates to the generation of income.

Income-generation

Clause 3.18.3.3. limits reference to the use of a trust as follows: "*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*."

Considering that the average lump sum benefit per dependant currently managed in trust is only approximately R30 000, the income thereon at current interest rates of approximately 6% per annum equates to R1 800 per annum, or R150 per month. Payment of only income into trust is not a viable option.

When fund trustees are faced with the challenge of generating income, the following can be considered:

i) Manage death benefits within existing retirement funds.

This has been dealt with under 1 (c) above, and the fact that most funds have opted to distribute death benefits to umbrella trusts is indicative of their inability to manage the funds cost effectively and to the maximum benefit of beneficiaries.

ii) Purchase an annuity

This option raises a number of concerns, relating to -

? legal ownership of the policy
? inflexibility with regard to access to capital for education
? a high cost structure and perceived lack of transparency
? the potential for an inappropriate investment policy
? possible tax inefficiencies

iii) Use an Umbrella Trust

The benefits of this service have been outlined in 2 (c) above, together with the following additional comments:-

Costs associated with umbrella trusts
With regard to the administration costs of umbrella trusts, the average annual cost per beneficiary is approximately 1,5% to 2% of capital. This equates in rand terms, using the average benefit payment of R30 000, to between R450 and R600 per annum (R37,50 – R50 per month), including bank charges.

Adding investment charges of approximately 1% per annum equates to a total cost of approximately 2,5% to 3%, which is at least 50% less than the recently reported average of 6% for retirement funds.

Taxation of umbrella trusts
Apart from the fact that an umbrella trust is a separate legal entity offering a focused service, it is also tax efficient in that the benefits vest in the hands of the beneficiaries, most of whom are below the tax threshold. The trust itself does not pay any taxes.

Conclusion

The use of an umbrella trust to receive lump-sum benefits for minor dependants and persons with a legal disability is already a viable cost-effective approach, offering flexibility a personal. tailored approach for each dependant with regard to income requirements and capital flexibility.

The underlying investment of a trust is structured according to the monthly income needs of beneficiaries and, where possible, depending on the size and term of the trust, capital growth. Thus each beneficiary's portion is invested according to his/her needs, and the investments are reblended regularly as income is paid and capital reduced when other needs of the beneficiary are met. Institutional investment returns are made possible through the bulking of funds.

Increasingly, lump sums held in trust are being used to educate dependants and, if by the time the dependant has reached the age of majority and the funds are depleted, an education has created the opportunity for employment and financial independence.

As an example: The average payout of R30 000, if used sensibly, can make a significant difference to the lives of beneficiaries. Assistance of approximately R1 000 per annum towards 12 years of schooling would still leave some funds available for tertiary education

Last but not least, families who have lost a breadwinner not only have the bereavement to cope with but often need advice on how to use death benefit funds to optimal benefit. Trust companies provide a gratuitous financial advisory and counseling role in many cases.

Recommendation

It is therefore recommended that section 37 C (2) be retained as an option to retirement fund trustees, whereby lump sum benefits can be paid into trust.

Section 37 C (2)

"For the purpose of this section, a payment by a registered fund to a trustee contemplated in the Trust Property Control Act, 1988 (Act No. 57 of 1988), for the benefit of a dependant or nominee contemplated in this section shall be deemed to be a payment to such dependant or nominee."