

MEMORANDUM

OF COMMENTS ON THE NATIONAL TREASURY RETIREMENT FUND REFORM DISCUSSION PAPER OF DECEMBER 2004, BY THE TASK TEAM OF THE INVESTMENT COMMITTEE OF THE INSTITUTE OF RETIREMENT FUNDS

1. INTRODUCTION

The comments to follow on the National Treasury discussion paper on Retirement Fund Reform have been compiled by a task team of the Investment Committee of the Institute of Retirement Funds. The scope of the comments are limited to the investment related matters contained in the discussion paper. The comments include the written submissions made by members of the Institute of Retirement funds as well as inputs made at the Hot Topics seminar held at Sandton on 3 March 2005 and at the Pension Lawyers Association conference held at Boksburg on 6 to 8 March 2005.

2. PRINCIPLES OF RETIREMENT REFORM

The broad principles of retirement reform as explained on pages 4 to 9 of the Discussion Paper is supported in general. The initiatives of National Treasury to give impetus to the process of retirement reform is appreciated. Although the purpose of the annexures to the Discussion Paper is to “detail the specific proposals” it is the opinion that more detailed specifications should follow on which the retirement industry should be afforded an opportunity to submit comments. The broad principles is a good departure point but a second round of public and industry related consultation before a formal document such as a white paper is issued will enhance the quality of such document and eventually expedite the finalisation of the process.

3. ANNEXURE 1: THE SOUTH AFRICAN RETIREMENT FUNDS LANDSCAPE

From an investment point of view no comments on Annexure 1 to the Discussion Paper are being put forward. Apart from making interesting reading the matter of leakage is of great importance. Leakage is a great concern for the retirement industry due to the negative impact on the replacement ratio at retirement. It is a perception that the general public is unaware of the dangers of leakage until it is too late to remedy it. It is suggested that a comprehensive public campaign be lodged to make the

general public aware of the disasters of leakage. That alone should shock them into action to become more savings orientated.

4. ANNEXURE 2: ACCESS, COMPULSION AND PRESERVATION

The notion of a National Savings Fund is commendable. Some of the items listed under paragraph 2.5.1.2 should however first be detailed and then circulated to the stakeholders for further comments. For instance the broader implication of the proposed exemption from Retirement Fund Tax as mentioned in paragraph (e) should thoroughly be investigated. Such exemption may lead to inequitable situations with regard to other occupational retirement funds. It is regarded prematurely to entertain such matter as the tax treatment of retirement funds will be the subject of a separate discussion paper. Although it is appreciated that South Africa has no pressing need for compulsory savings at this stage, it is suggested that an open mind be preserved to consider mandatory saving systems, such as the National Savings Fund, if the education on the desirability of voluntary saving for retirement does not bear the required fruit.

5. ANNEXURE 3: BENEFITS, CONTRIBUTION RATES AND MEMBER PROTECTION

- (i) The adequacy level of replacement value of 75% of final year's earnings is noted. Although this is regarded as the ideal in a perfect world it is doubtful whether such a high goal is attainable. Being unattainable by the majority of the working population it might be regarded as unrealistic and the whole effort to get the public at large to buy into a savings awareness culture, may fail. It is suggested that the 75% level be set at a more humble level such as 60% or 65% taking into account the current socio-economic situation of the South African population at large. This level can always in future be increased, taking the population along.
- (ii) The fluctuation of contribution rates are fully supported from an investment point of view. It makes common investment sense that as a member matures in his career he may be in a better position to contribute at a higher rate. It is however suggested that the limit recommended by National Treasury in paragraph 3.6.3 be reconsidered. The Income Tax Act makes provision for the deduction on exit of contributions exceeding the tax deductible contribution by a member. (Formula B of the Second Schedule). It is believed that no disincentive on savings should be introduced.
- (iii) Another significant matter addressed is the form of benefit payment in paragraph 3.7. The notion to pay benefits in the form of an **income** after retirement, disability and death instead of a **lump sum** is essential for sensible retirement provision. However to promote such notion amongst the potential members the reason for

preference of a lump sum payment must be considered or rather the reason why income payments are not popular. The main reason obviously being the approach that all residual monies in the fund would be forfeited at death. If this concern could be addressed successfully by, for instance requiring that a percentage of the residual should be paid to the deceased estate, it would go a long way in winning potential members over to income payment instead of lump sum payment. It is appreciated this is a subject that needs proper actuarial investigation and it is suggested that this matter be fully unpacked in a further phase of the process, for instance what a “modest proportion” would be.

- (iv) A very controversial matter addressed in paragraph 3.15 is the access to retirement savings during employment. In paragraph 2.15 of Annexure 1 to the Discussion Paper concern is raised about leakage as being the major reason for people retiring with insufficient retirement benefits. If National Treasury is committed to address the disastrous effects of leakage it is suggested that the access to retirement savings during employment through housing loan guarantees and for other life crisis needs as discussed in paragraph 3.15 be reconsidered. Housing loans is a major case of leakage. It is hugely abused in certain sectors of the industry. It is true that “strict controls must be in place to prevent abuse” as mentioned in paragraph 3.15.1.4 (f). However in practice it is a total different reality. Sufficient control is almost impossible taking cost factors into consideration. Unless a fully fledged inspectorate is engaged consistent control cannot be exercised. It is agreed that retirement funds should not engage in housing finance business. The dangers of such as mentioned in paragraph 3.15.1.3 is endorsed. The suggestion that allow only housing loan guarantees instead of direct housing loans be allowed is not a solution to the problem of abuse. There is little incentive to a financial institution to exhaust all possible avenues to collect arrear instalments from a defaulting borrower if such institution can recover the outstanding loan from the retirement fund. This in reality means that such recovering is an early withdrawal with detrimental affects on a members retirement provision aggravated by the tax implications of paragraph (eA) of section 1 of the Income Tax Act, 1962. There are funds in the retirement industry which use access to retirement savings during employment through housing loans as a marketing tool. Some funds act responsible by allowing modest maxima of a members fund value to be utilised for a housing loan however some funds allow irresponsible levels of member fund values to be committed to housing loans and/or housing loan guarantees. Although the scope of this memorandum is limited to an investment perspective on the proposals in the Discussion Paper, the leakage through housing loans is so detrimental that it is regarded

necessary to point it out in this memorandum. Such leakage impacts directly and negatively on the income replacement values and adequacy levels which the Discussion Paper wishes to promote.

The possibility of allowing access to retirement savings during employment for “other crisis needs” would aggravate the situation. If such is the intention, the commendable goal of the National Savings Fund will be compromised. In such event it would be no different from a savings account and does not warrant any favourable tax dispensations other than for a normal savings account. To then call it a National Savings **Fund** will do injustice to the meaning of a fund and should it rather be called the National Savings **Account**. It is suggested that the proposals on the access to retirement savings during employment be the subject of a further round of discussions. However if the National Treasury Task Team is convinced about the recommendation then at least housing loan guarantees as well as direct loans should be allowed because there are retirement funds which give direct housing loans and apply more rigorous processes to collect arrear contributions than are applied by some financial institutions knowing that the outstanding loan can easily be recovered from the retirement fund in terms of the guarantee. It is also suggested that housing loan guarantees and direct loans be limited to 30% of a member’s fund value, thus preserving the majority of the retirement savings for the purpose it is intended. It is noted that the Mouton Report and the Taylor Report favour the use of retirement savings to finance the purchase of homes. In principle this view is supported but in practice it creates an undesirable leakage of retirement savings due to abuse. It will also prevent retirement funds to allow levels of 80% and 90% as a marketing tool.

6 ANNEXURE 4: GOVERNANCE AND REGULATION

As the focus of this memorandum is on an investment perspective paragraph 7, Investment Regulation, is of specific relevance. The contents of paragraph 7 is supported in general. Unfortunately the matter of investment regulation is not dealt with extensively in the Discussion Paper. It merely reflects that “the National Treasury Task Team recommended 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.” It then goes further to be more specific in paragraphs 7.5 and 7.6. The draft regulation 28 has been under discussion for some years already. The latest position, before the publication of the Discussion Paper, of being shelved until National Treasury finds an appropriate opportunity to deal with it. It is not clear

whether the inclusion of paragraph 7 in the Discussion Paper is in actual fact the utilising of such opportunity and whether a further opportunity for detailed consideration of investment regulation will be allowed. It is suggested that paragraph 7 of the Discussion Paper be regarded merely as a first phase frame work for investment regulation and that the detail be the subject of a further phased project. The following comments on the contents of paragraph 7 is however put forward in the meantime.

Ad paragraph 7.1

The contents are noted.

Ad paragraph 7.2

Although the notion of shareholder activism is supported the flip side of the coin, namely the responsibility and possible liability, should also be noticed. In order to exercise shareholder activism the trustees of a retirement fund need to be knowledgeable on the specific companies invested in as well of the full implications of the actions of such companies. It is doubtful whether the average retirement fund trustee is currently knowledgeable to exercise shareholder activism on a consistent basis. Comments on the lack of proper formal training and qualification requirements and the dire need for such is not within the scope of this memorandum.

Ad Paragraph 7.3

Socially desirable investments are supported but should not be done at the expense of the members of a retirement fund. See also ad paragraphs 7.6.3 and 7.6.4 below.

Ad Paragraph 7.4

The notion of “member investment choices” needs intensive discussion and should be regulated in detail to protect members and funds alike. It is especially the matter of investment advice that goes along with investment choices that may create a plethora of legal problems for retirement funds and their trustees with certain cost implications for the members themselves. It is suggested that the South African population at large is not financially sophisticated enough to introduce unlimited member investment choices. The last sentence of paragraph 7.4 is quite significant and should not be under estimated. See also ad paragraph 7.6.5 below.

Ad Paragraph 7.5.1

The specific levels of the maxima to be set for investment in any single investment and investments outside the RSA should be one of the matters to be included when the detail of investment regulation is further discussed as suggested above. It is debatable whether the maximum to be invested offshore should be included in retirement fund investment regulations on whether it should be regulated through exchange control regulation. Some regard the limit of 10% to be invested in participating employer companies as too restrictive. However investment in participating employees should not be allowed at all, unless it is individually approved by the Regulator taking into account the specific circumstances. The examples of the Enron's of this world should be heeded to prevent both a possible job loss as well as retirement savings loss for an individual.

Ad Paragraph 7.5.2 to 7.5.5

The principles contained in these paragraphs are sound but need more detailed specification in order to comment meaningfully.

Ad Paragraph 7.6.1

There is a dire need for proper relevant benchmarking however it should be applied in such way that the current "herd instinct" is not fostered. A fund should also be required to formulate its own benchmark in accordance with its investment strategy goals. The matter of benchmarks is also to be discussed in detail with the industry during a further phase of investment regulation formulation.

Ad Paragraph 7.6.2

The term "regularly" is undefined and needs to be specific. It must however be clear that regular monitoring, say for instance quarterly monitoring, does not necessarily warrants action. Trustees should be encouraged to take long term views in stead of acting on short term investment returns.

Ad Paragraph 7.6.3

It is suggested that "socially desirable investments which are likely to yield returns lower than those which may be expected of other investments by the fund" should be measured according to the risk adjusted returns and should not lag behind other investment vehicles measured in terms of such risk adjusted returns.

Ad Paragraph 7.6.4

SDI's should only be made if the risk adjusted return compares favourably with the other investment vehicles and if it fits in with the investment strategy of the fund. It should be a prerequisite that the investment policy statement of fund also include in detail the policy and risk limits in respect of SDI's.

Ad paragraph 7.6.5

Although some regard the limitation of investment choices as paternalistic it is suggested that the "limit of, say 3 or 5" may still be too wide. A maximum of 3 choices may be more appropriate for the South African environment. It may even be considered that in the event where a fund has a life stage model (default options) that member choices be limited to only one other investment channel. For example if a fund has an aggressive, moderate and conservative life stage according to age groupings it may be sufficient to only allow a member to move all or a portion of his investment to a capital guaranteed option because of personal circumstances such as his plans to resign from his occupation and to exit the fund at an early stage say in two years time, at age 40, to start up a business. In such event short term market fluctuations can be detrimental to such person and requires pro-active measures.

CONCLUSION

- * Attached as Annexure A to this memorandum is a copy of a newsflash written by Magde Wierzycka of African Harvest Fund Managers which should be read together with this memorandum.

The point made at various discussion fora the past two months namely that new regulatory measures should be phased in to not impact negatively on existing vested rights is again re-iterated. For example an individual may have planned his retirement and may have based his total estate planning on the current dispensation where he receives a lump sum benefit from his provident fund. New regulatory provisions should take such possible scenarios into consideration and should make provision for gradual phasing. It is confirmed that National Treasury indicated at the various fora of discussion that new measures will be implemented in such way that existing vested rights are not detrimentally affected.

INVESTMENT COMMITTEE TASK TEAM: INSTITUTE OF RETIREMENT FUNDS.

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