The South African Institute of Chartered Accountants

31 March 2005

National Treasury
Private Bag X115
Pretoria
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Email: retirement @treasury.gov.za

Dear Sir/Madam

DISCUSSION PAPER ON RETIREMENT FUNDS REFORM

We would like to thank you for the opportunity to provide comments on the Discussion Paper – *Retirement Funds Reform.*

In response to your request for comments, please find the submission prepared by the South African Institute of Chartered Accountants (SAICA) which reflects the views of its members, the Retirement Funds Committee and the National Tax Committee of SAICA.

Please do not hesitate to contact us should you wish to discuss any of our comments.

Yours sincerely

Desrae Lawrence
Project Director – Standards

cc: Karin Biggs (Chairperson of the Retirement Funds Committee)
cc: Nithia Nalliah (Chairperson of the National Tax Committee)

GENERAL COMMENTS

We commend the National Treasury task team on preparing a very comprehensive and well thought out discussion paper on retirement reform in South Africa. We acknowledge the difficulty in addressing the problems experienced by this country, given the vast majority of the population living below the bread line and the significant number of people employed in the informal sector. The discussion paper addresses all sectors of the population satisfactorily.

We support the contents of the discussion paper and set out our comments on certain aspects which we believe require further consideration. We note that the issue of taxation of retirement funds will be dealt with in another paper. However, given that it is extremely difficult to properly evaluate and consider the current proposals without having sight of the tax issues we have, for certain aspects considered the taxation effects.

SPECIFIC COMMENTS

National Savings Fund

Means test exemption
In clause 2.5 the National Treasury task team proposes a new savings vehicle, the National Savings Fund (NSF), especially for people with low income. The discussion paper further proposes that government should exempt benefits paid from the NSF from the means test in determining whether an individual qualifies for the social old age pension. We fully support this exemption if the NSF is to cater for individuals with lower income, in particular persons employed in the informal sector, seasonal employees, domestic and agricultural workers, etc.

However, it is our view that it would be unfair to limit exemption from the means test exclusively to members of the NSF, whilst members of other funds earning at the same level of income are denied such exemption. In order to encourage savings whilst at the same time providing freedom of choice with regard to the retirement fund selected, it is proposed that exemption from the means test remain based on the level of income of the member and not on membership of any particular fund.

Bonus payment
It is proposed that the NSF should pay a bonus if the individual retains his/her funds in the NSF until retirement. It is our view that this proposal may result in cross-subsidy between people who are in the NSF for a short period of time and those who are in the NSF longer. It would be difficult to produce a bonus system that would be equitable and fair and members of the NSF would have to understand how the bonus system works, so that they are not unfairly prejudiced by early withdrawals from the NSF. The recommended approach also appears to contrast with the approach contained in the Pension Funds Second Amendment Act, 2002, whereby members of defined contribution categories of funds are treated the same regardless of the length of time that they remain within a fund.

Retirement fund tax
The discussion paper proposes that the NSF be exempt from the payment of retirement fund tax. We trust that the issue of the retirement funds tax will in itself be subject to an extensive review as part of the review of the entire retirement fund provisions. It is suffice at this point for us to state that the retirement funds tax is an inequitable tax in that it is a double tax and also taxes the interest income which is earned by the fund for the benefit of low income employees whilst the low income employees would have been entitled to the annual interest exemption if such interest income was earned by them personally. The retirement funds tax is currently counter-productive to employees saving for their retirement.

It is proposed that the NSF would have contributions from after tax income and the investment income earned in the NSF be taxed as private savings whilst the benefits that are paid out from the NSF be exempt from tax. We do not support this approach if the NSF is meant to cater for the low income employees. Our principal reason is that there should be some incentive for employees to contribute to the NSF and if they will not enjoy any tax relief, there would be little incentive to contribute to the NSF as opposed to them saving in any other vehicle whereby they may access their funds at any point in time e.g. bank savings account, fixed deposit investments, call account, collective investment schemes, etc. Furthermore, the taxation of the investment income in the NSF would run counter to the fact that the low income employees currently qualify for the R15 000 per annum interest exemption which would not be made available if their savings are in the NSF.

Capital EEE vs. TTE approach
We strongly support the so-called Capital EEE approach for the NSF if the NSF is primarily there to cater for the low income earners. We do not necessarily agree with the comment in clause 2.5.1.2(e) where it is stated that the so-called TTE approach is essentially an EEE approach. Our reason is that the tax threshold is currently R35 000 per annum for persons under the age of 65 but in addition such individuals are currently entitled to earn interest income which would be totally exempt up to a maximum of R15 000 per annum. This interest exemption would be ignored in a so-called TTE approach.

We prefer the alternative proposed in the paper whereby the contributions into the NSF would be limited to a percentage of the tax threshold per individual saver or the deductions of the contributions from the tax deductible amounts available for occupational and individual retirement funds or lastly deducting the interest payable from the NSF from the tax-free interest allowance for income tax purposes. We suggest that the alternative approach be examined further in preference to the so-called TTE approach.

Differentiation

Clause 3.5.1 states that amongst others the so-called self employed persons should also be entitled to provide for retirement funding without being prejudiced as they currently are in that they do not qualify for any tax relief, save to the extent that contributions are made to a retirement annuity fund. We fully support this proposal as these persons are currently forced to incorporate merely to take advantage of retirement funding provisions. This is not productive expenditure where structures are created solely to take advantage of tax benefits for retirement funding provisions. A classic example is partners in professional partnerships who are prejudiced in that they do not qualify for any deductions to pension fund.

With regard to clause 3.5.2.2 we submit that in many cases, differentiation in fund rules on the basis of salary level and employment grade is merely the result of the fact that for certain employees earning below a certain salary level, in particular those earning below the tax threshold, the benefits of membership of a tax approved occupational fund do not justify the costs of fund administration of such fund. It is our proposal that instead of being prescriptive with regard to the conditions for membership, employees earning below a certain level be permitted to join the NSF or an appropriate individual retirement fund and that the proposals set out in clause 1.6.1.2 be applied to such employees.

Regarding clause 3.5.2.3, we wish to point out that the recommended prohibition against material differences in benefits due to age or gender differences contradicts the principles of the Minimum Individual Reserve calculation in respect of a defined benefit fund, as outlined in section 14B(2)(a)(i) of the Pension Funds Act.

Clause 3.5.3.2 states that no employee who is below the tax threshold should be compelled to join an occupational or individual retirement fund and such employee should be entitled to join the NSF instead. Whilst we are in agreement with this in principal, consideration needs to be given as to how this will be achieved practically since an individual may be below the tax threshold in one year but in a subsequent year may find him/herself over the tax threshold and in another year may then fall below the tax threshold once again. The tax thresholds increase each year as tax rates and rebates are changed.

Individual Retirement Funds

We are in general in support of all the proposals made with regard to Individual Retirement Funds, but have the following comments regarding two of the recommendations made:

(a) The reason for the proposal that transfers between such funds be allowed on condition that the transferee fund meets conditions applicable to the transferor fund is unclear.

(b) It is further unclear as to why intermediaries that introduce members to individual retirement funds, or financial services providers licensed in terms of the Financial Advisory and Intermediary Services Act and who might provide a valuable service in terms of providing advice to the member on the appropriate choice of fund, be denied the opportunity to earn an income for their services. It is our view that such provision would discourage the investment of retirement savings within a recognised retirement funding vehicle and might provide an unfair (and sometimes inappropriate) incentive to intermediaries to sell individual insurance products. We are of the opinion that legislative requirements relating to full disclosure of commissions and costs will place members in a position to assess whether the payment of such commissions in respect of a particular product is justifiable.

Ancillary Benefits

Clause 6.5.1.3 provides that, in the event of the insurance premiums or administration expenses increasing, the insured benefit levels should be reduced appropriately as opposed to reducing contributions to the retirement savings. In principal this seems to be fair, but we wish to point out that insurance premiums generally increase as a result of increased risk in relation to the member. It is at such point in time that one would not want to reduce the insured benefit as the total benefits to be paid to the individual in the event of the insured risk coming to fruition would be reduced. We suggest that the retirement savings contribution should be reduced but should have a minimum below which the contributions should not reduce.

We welcome the proposals with regard to the pre-funding of medical aid contributions in respect of pensioners and employees for post-retirement funding medical costs.

Adequacy of Retirement Benefit

The principal of encouraging savings by increasing the tax deductible limits when the employee attains the age of 40 appears to lose sight of one important factor. In cases of retrenchment it is general practise for older employees to be retrenched, which means that if an employee has not commenced saving for his retirement at an early age, even at lower amounts, such employee could well find him or herself without retirement savings. We are of the view that if employees are to be encouraged to save there should be tax incentives which should be based on monetary limits as opposed to merely working on an employee’s age. There may well be a place to allow employees a greater tax deductible contribution from age 40, e.g. where such employee comes onto the labour market at a much later age.

We note that the National Treasury recommendations on the maximum tax deductible contributions towards retirement savings are to be examined at a later stage. It is suffice at this stage for us to state that any limits should be based on a percentage of income as opposed to fixed monetary limits. There could well be a monetary cap on the contribution but the basic calculation should firstly be on a percentage of earnings.

Pension Increases

In clause 2.4.2 the National Treasury task team recommends that, in certain instances, the assets required to back the pension liability be invested separately and the benefit of the investment return be passed onto the pensioners. Whilst this again is acceptable in principle, there are certain factors that need to be taken into account in the practical implementation thereof. For example where one has significant movement in interest rates over a period of time as was the case in South Africa until recently. It has to be ensured that such pensioners do not have fluctuating pension benefits from month to month, with their pension benefits being reduced as the interest rates reduce.

We welcome the fact that the retirement savings is to be protected from the employer regardless of the employee’s actions in relation to the employer. Given that the retirement benefits are meant to be protected in the event of insolvency, the employer should not be granted certain preferences to attach the employee’s benefits. We believe this proposal is long overdue in that it now separates the employee's retirement savings from his or her other assets.

Benefits Available from a Retirement Fund

Fluctuating rates of contribution
Clause 3.6.3 addressing fluctuating rates of contribution, recommends that the rules of the fund allow for variation in contribution rates. It further states that this is subject to the proviso that the limit on the tax deductible contribution by member and employer combined is not breached. We believe that further consideration needs to be given to allowing a member or employer to make additional contributions to a retirement fund regardless of whether such amount will qualify in full for tax deduction. In other words, the member and/or employer should not be precluded from making additional contributions to the retirement fund merely because the tax deductible amounts are capped.

Form of benefit payment
Clause 3.7.2 and 3.7.3 of the proposal states that the new Retirement Funds Act should prescribe the payment of only a modest proportion of the benefit in the form of a lump sum. It is clearly preferable for an individual to receive an annuity as opposed to a lump sum. However, we would strongly recommend that this be phased-in as opposed to withdrawing the lump sum provision immediately upon the new Retirement Funds Act coming into effect. For example, where the employee is entitled to a lump sum upon retirement, such lump sum could be reduced by say 5 or 10 % each year from the date of introduction of the new Retirement Funds Act. This would also ensure that there is not a mass exodus of employees from their current retirement funds just prior to the promulgation of a new Retirement Funds Act.

Post retirement medical funding
Clause 3.8.4.2, that addresses the post retirement medical funding, the alternative proposal is that the medical aid contributions be paid from the special account, as opposed to requiring such amount to be contributed to another fund to purchase an annuity. We believe that the purchase of an annuity comes with significant additional costs which would be unnecessary if the amount could be paid from the special fund, without the need for an annuity being purchased separately.

Loss of employment
With regard to clause 3.11 relating to loss of employment, we acknowledge the fundamental issues and concerns with regard to payment of benefits to employees who lose their jobs through no fault of their own. The National Treasury task team supports the principal as recommended by the Taylor Report, that the employee be permitted to access their retirement savings only after the unemployment benefit has been exhausted. We would like to add that, upon the Unemployment Insurance Fund benefits being exhausted, the employee should draw an annuity based on his/her last income or a percentage of such income until such employee finds new employment, as opposed to allowing such employee to access a lump sum. This would ensure that the individual's household receives a monthly income similar to his/her employment income until the individual finds new employment.

Interest on late payment of benefits
We note that clause 3.13.2 dealing with interest on late payment of benefits, provision is made for interest to be paid under certain circumstances. The recommendation by the National Treasury task team is 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. However, there may well be a delay between the date of withdrawal from the fund and the date that the claim is admitted and provision needs to be made, to ensure that interest or other compensation is paid to the member from date of withdrawal, resignation or retirement and not merely from the date when the members interest in the fund is converted into cash.

Unclaimed benefits
The recommendation with regard to unclaimed benefits is welcome. However, clause 3.14.3.4 needs to take into account the issue of prescription if applicable. We presume that there would be a prescription period even if such period is 10, 15 or 20 years from the date that the member employee withdraws, resigns or retires from the fund. In the absence of any prescription the benefits would have to be retained forever which would not be practical.

Housing loans and guarantees
The provisions and recommendations dealing with housing loans and guarantees is welcome as funds will no longer be permitted to make housing loans, but merely provide guarantees to a financial institution. This proposal acknowledges the fact that these are vehicles to provide for retirement funding for employees and not housing benefits, notwithstanding the dire need for funding for housing.

Clause 3.15.1.4(e) requires that the loan taken must be in respect of the member's and his/her spouse's primary residence. Consideration needs to be given to the fact that an employee may dispose of his/her primary residence, realise a profit and not utilise such profit in acquiring another primary residence. Instead he/she may seek to obtain a loan and thus require a housing guarantee from the retirement fund. Mechanisms would have to be introduced to counteract his potential abuse.

Other life crisis needs
Whilst we acknowledge the need for some flexibility in the NSF as set out in clause 3.15.2, we are concerned that if the employee is permitted to withdraw the savings for any purpose, individuals would not use the NSF to save for retirement but would constantly withdraw benefits. We believe that loss of employment may well necessitate a withdrawal of savings but this should be on a monthly withdrawal calculated with reference to the last wage or salary as opposed to a lump sum withdrawal. With regard to other life crises needs e.g. hospitalisation, major medical or death, limited withdrawals should be permitted having regard to the individual circumstances.

Payment of benefits on death
Clause 3.18, dealing with payment of benefits on death recommends trustees be obliged to require fund members, at least once every 5 years, to state in writing the identity of all their dependants, etc. Given that members may well change their residence and contact details more frequently than 5 years, we suggest that this be

required every year or at least every 2 years. This will ensure that the funds have more up to date information on the members and their dependents.

Payment of benefits on disability
We support the recommendation in relation to paying an income on temporary and permanent disability as set out in clause 3.19.3.1, payment of benefits on disability. However, we would suggest that such amounts be calculated after taking into account any other benefits which the employee may have qualified for as a result of the temporary or permanent disability, e.g. occupational disability payments, insurance benefits, etc.

Investment Regulation

We welcome clause 7.6.1 that proposes that the regulator be required to suggest benchmarks against which the performance of asset managers may be assessed from time to time. This will provide the trustees with more independent information, which may be used to evaluate its asset manager's performance.

Clause 7.6.4 makes a new proposal to permit an investment of up to 10 % of the assets in such investments through collective investment or private equity schemes. Whilst we welcome the investment in collective investment schemes, the higher risks associated with private equity schemes will need to be factored into account in this recommendation. We suggest that a lower percentage be permitted in relation to investment in private equity schemes given that these are unlisted investments and often not subject to the same regulations as listed companies.

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