PRESS RELEASE

RETIREMENT REFORM: LOWERING CHARGES AND IMPROVING MARKET CONDUCT

National Treasury today takes the first step towards implementing proposals that aim to lower charges and improve market conduct in the retirement industry. These proposals form part of the broader retirement and savings reforms initiated in 2011, outlined in the document *2014 Budget update on retirement reforms*, released on 14 March 2014. The improvements in market conduct for the retirement industry are also in line with the Treating Customers Fairly initiative and the Retail Distribution Review currently underway, led by the Financial Services Board.

The draft default proposals published for public comment today follow from the Treasury paper, *Charges in South African Retirement Funds*, published on 11 July 2013. This paper found that parts of the South African retirement system are characterised by complex and opaque products, with high charges. These factors make it impossible for consumers and employers to exercise choices in a way that leads to best outcomes for members of retirement funds. Low rates of preservation and participation in the retirement system, particularly by lower paid workers, exacerbate the problem, leading to higher than necessary costs and charges.

The draft default regulations are published in terms of section 36(1)(c) of the Pension Funds Act, No. 24 of 1956. The draft regulations, when adopted, will require all retirement funds to operate a set of default policies that are in the long-term interests of members rather than of service providers. The regulations will also prescribe the conditions that such default policies are required to meet.

As outlined in Annexure D *(Financial sector regulatory reforms)* of the 2015 Budget Review, further proposals to deal with fund consolidation, standardisation, mandation of membership, and improving governance will also be finalised over the next few years. These proposals follow on legislation already enacted to harmonise the treatment of retirement funds, including a more equitable system of tax deductions for contributions, as well as enabling tax-free savings since 1 March this year. The Tax Laws Amendment Bills published today also contain proposals to close loopholes to ensure that no retirement funds are inadvertently excluded from reform measures already enacted.

What role do defaults play in the retirement system?

Default options are automatic choices made on behalf of members who do not exercise their choices in a given situation. There is currently no requirement for funds to provide default options, and, where they exist, current defaults often favour the interests of service providers, often working against the interests of members. Such bad default options include:

a) Not protecting or supporting members when they withdraw from a retirement fund before they retire; members incur tax liabilities as no preservation fund options are provided. For most, the easiest path ends up being to take their retirement benefits in cash, even if they intended to preserve the funds;
b) Forcing members into active asset management with high charges, not allowing the option of passive investment management, which often has lower charges and higher long run returns net of charges;
c) Not assisting members on their retirement, but leaving them to make their own choices in the retail market, and losing the opportunity to use the economies of scale, expertise and bulk buying power of funds in the interests of members; and
d) Automatically placing members in complex default investment options with high exit charges and expensive guarantees.

International research shows that replacing bad defaults with good defaults can significantly improve outcomes, since individuals who are defaulted into certain decisions, choices, products or strategies, tend to remain in those options. Ensuring that defaults are appropriate, that they serve the members' best interests and provide good value for money is therefore of paramount importance.

The draft regulations being released today require funds to have default investment portfolios for the investment of retirement savings, default annuity strategies for members upon their retirement, and default preservation rules for members on termination of membership before retirement. The aim of the default strategies is to reduce complexity by requiring retirement funds to develop cost-effective, standardised and easily accessible products during the accumulation phase, when members withdraw from funds before they retire, and when members convert their retirement savings into an income upon retirement. The default regulations will provide guidance to trustees in ensuring that retirement funds serve members' best interests, even when members are not fully engaged with their retirement funds.

Default investment strategy:

In many cases, individuals are automatically defaulted into investment strategies that have complex and high charges, complex policy conditions, exit penalties and/or expensive guarantees. Most individual members of retirement funds, and indeed many trustees, are not provided with the option of investing their funds in passive investments.

The default investment strategy regulation will require all defined contribution retirement funds, including retirement annuity funds, to have in place a simple, cost-effective and transparent default investment strategy into which the retirement savings of members that do not make any investment choice should be invested.

Trustees should ensure that the overall objective, composition and performance of the default investment portfolio are appropriate for members and that the defaults are adequately communicated to members in a clear and understandable language.

Further, fees and charges in respect of the default investment portfolio or the assets held in respect thereof need to be reasonable, competitive and regularly disclosed to members.

Defaults must be simple: performance fees, loyalty bonuses or similar charge structures are not permitted for default investment portfolios. Members should not be locked into a default investment portfolio, but should be able to transfer from one portfolio to another. Default investment strategies may not contain any insurance element, but must be purely for investment purposes, and payouts cannot depend in any way on the reason for a member's exit.

To increase the visibility of passive investment of listed assets in South Africa, the default regulation requires trustees to consider passive or enhanced passive investment as part or all of the default investment portfolio.

Default annuity strategy:

The current system provides no protection to members when they retire or exit a fund, making it too easy for individuals to fall prey to unscrupulous advisors or make the wrong investment decisions. All retirement funds should have a responsibility to assist exiting members, many of whom are at their most vulnerable when they retire, with no financial advice provided. All defined contribution retirement funds, including retirement annuity funds, will therefore be required to have in place a default annuity strategy.

Various products can form part of the default annuity strategy. For example, in-fund guaranteed pensions, in-fund living annuities, in-fund with-profits pensions, and certain out-of fund life annuities guaranteed by a life office are all permitted. Trustees may also mix different products as part of the strategy. Members can however opt out and move into other annuity products of their choice if they wish. Funds must also make retirement benefit counselors available to members on retirement to assist them in understanding the default annuity strategy.

Similar to the provisions of the default investment strategy, the default annuity strategy also needs to offer good value for money, be well communicated to members, have all fees and charges disclosed and be reviewed regularly to ensure compliance with the regulation.

Default preservation strategy:

Many members who exit a fund are not provided with any advice on the different options they have and the effect of these options. Too often, the practical consequence is that retirement savings are paid as a cash lump sum, with consequent tax liability and a greater risk of an inadequate income in retirement. Low rates of preservation also have the effect of increasing costs for members, as the total size of the retirement system is reduced.

All retirement funds into which members are enrolled as a condition of employment are required to have a default preservation strategy. The aim of the strategy is to ensure, as far as possible, that members' retirement savings will follow them automatically from job to job as they change employment throughout their careers.

Retirement funds are required to make provision for 'paid-up members' – that is, members that are no longer employed by the sponsoring employer and therefore no longer actively contribute to the fund. Such members must automatically be made 'paid up members' when they leave the employment of the sponsoring employer, and be presented with a paid-up membership certificate, recording their interests in the fund.

Provision should also be made to allow new members to transfer retirement savings into a fund from other funds. When members join a new fund, the new fund must request their paid-up membership certificates and automatically transfer member's retirement savings in respect of those certificates into their new fund unless members request otherwise.

If members wish, they will still be able to withdraw their retirement savings when they leave the service of an employer, or preserve their funds in another fund or insurance policy of their choice, but such choices must be at their written request. Members wishing to withdraw their retirement savings should be given access to a retirement benefits counselor.

To prevent charges from being shifted onto paid-up members, recurring charges may not differ between active and paid-up members, and initial charges may not be levied when members become paid-up. No further contributions will be allowed if a member opts to preserve within a fund of a former employer.

The various default strategies (preservation, investment and annuitisation) developed by funds should be compliant with all the standards, principles and rules prescribed in the default regulations including regulation 28.

The draft default regulations are available on the National Treasury website (www.treasury.gov.za). Comments on the *Draft Default Regulations in terms of section 36(1)(c) of the Pension Funds Act, No. 24 of 1956* can be submitted by 30 September 2015, to Ms Alvinah Thela, Director: Retirement Funds, Private Bag X115, Pretoria, 0001; or fax to (012) 315 5206; or per email to retirement.reform@treasury.gov.za

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