Comment on National Treasury's discussion paper on Pension Fund Reform from a social security perspective

Social Security Committee (SSC) of the Actuarial Society of South Africa (ASSA)
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This commentary is solely that of the SSC and not that of ASSA members in general. The commentary is additional to the general commentary by ASSA, most if not all of which is supported by the SSC. Loosely it tackles the following issues:

- National pension age
- Means test
- National Savings Fund (NSF)

National Pension Age

It can be strongly argued that the qualification age for the Social Old Age Pension (SOAP) benefit should be normalised between the genders. This can be done in several ways:

- females phased to 65
- males phased to 60
- both males and females phased to an intermediate age e.g. 62

It should be noted that the phasing in period could possibly last decades as is the case in the UK.

Another possibly useful normalization is that the tax benefit in the form of an additional income tax rebate also be aligned with the above (currently 65).

This can then be confidently regarded as a "National Pension Age" or NPA.

A further normalization is that the Labour laws can be aligned so as to make dismissal solely on the grounds of old age unfair below the NPA. The law can be made flexible to allow exceptions in specific occupations on application e.g. airline pilots.

It may be necessary to adjust the NPA with time as the general mortality of the population improves – specifically if the State is to provide an annuity guarantee (see below). These adjustments can be done gradually over time and in such a way so as not to adversely affect retirement planning (in the UK for example the 5 year adjustment for females was done over a period of 10 years more than 20 years in the future).

A useful benchmark may be that the life expectancy at NPA, say LENPA be defined as a target percentage of NPA+LENPA. This would also reduce the inter-generational cross-subsidy of the SOAP.

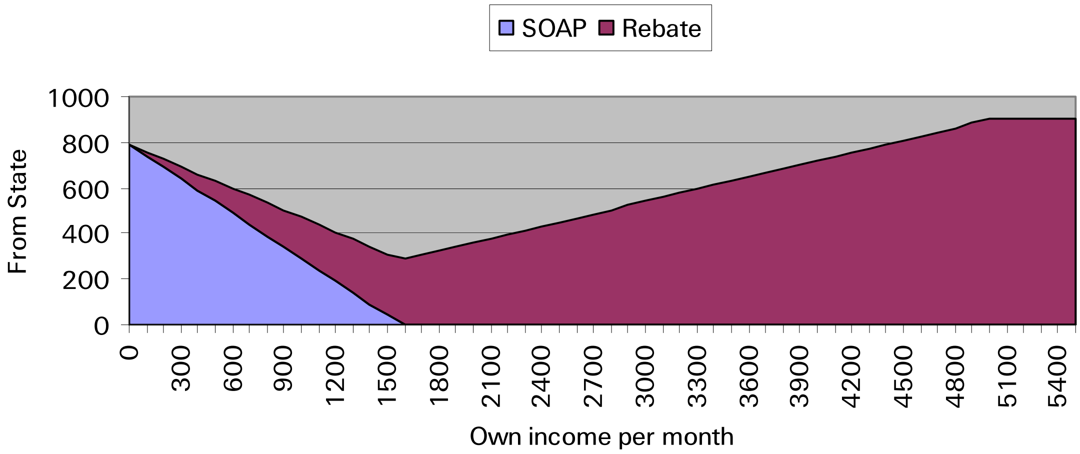
Means test

Means testing has inherent appeal in that it allows the State (in the case of the SOAP) to pay a bigger benefit to fewer beneficiaries. If it weren't for the additional cost, scrapping the means test would have the following appeal:

- lower administration costs (even given an increase in the number of beneficiaries and certainly in the context of the NSF)
- lower fraud levels

The state provides another "fixed" benefit to pensioners other than the SOAP (currently R790 per month). This is the tax rebate of up to R900 per month (basic rebate of R525 per month and additional "older persons" rebate of R375 per month). Whether by coincidence or design, this is similar to the current level of the SOAP.

The graph below illustrates the effect of these State transfers.



Clearly it is those with some of their own income (especially in the range R1 200 to R2 400 per month) that are the losers. Higher income earners (more than R5 000 per month) are indifferent. The reason for that is that the SOAP is reduced by 50% of own income whereas the lowest marginal tax rate is only 18%. Effectively those receiving the SOAP experience that same effect as a marginal tax rate of 50%.

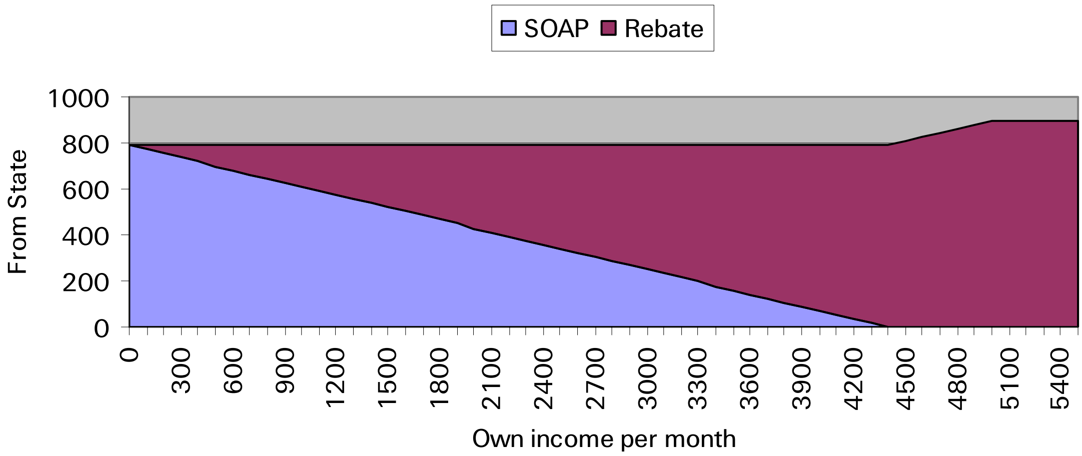
The discussion paper aims to fill this gap by excluding income from the NSF from the SOAP means test or in effect taking away NSF income from 'own' income above. Thus the cost will be borne in any event.

This does not help the person in this category with some income say from an occupational retirement fund or say rental income. It is also more complicated and clashes with the principle of tax harmonization.

Two more robust methods are:
- Adjusting the means test
- Abolishing the means test

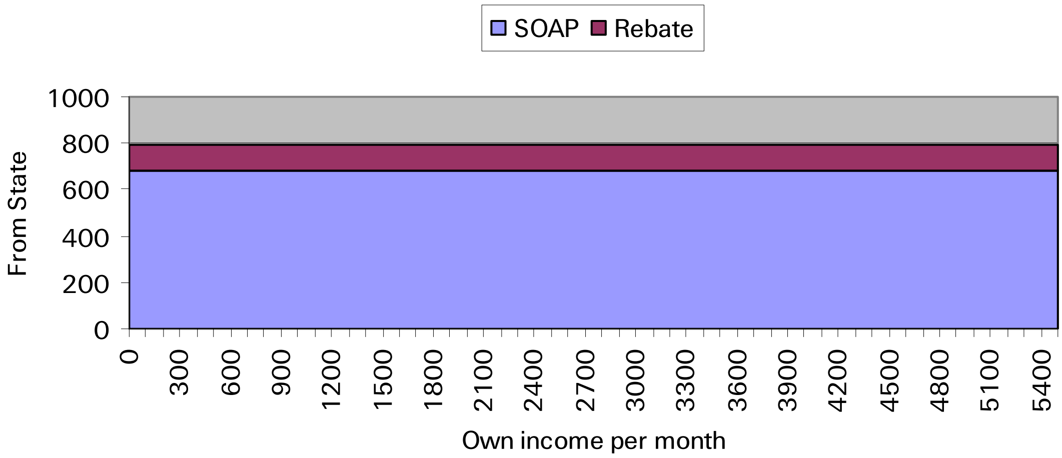
Adjusting the means test

If the SOAP reduction was changed from 50% of own income to 18%, the above disparity would disappear.



Abolishing the means test

A second method is to abolish the means test and to reduce the rebate by R790 per month.



The difference between these methods for the higher earning pensioner is cosmetic i.e. loss of rebate compensated for by SOAP. For the lower earning pensioner this has the advantage of not needing to provide information for the means test. For the State the clear advantage is reduction of administration costs (application of means test) and losses via fraud (from those claiming both means tested benefits and a tax rebate).

National Savings Fund

The concept of the NSF is a good one. National Treasury Task Team (NTTT) has called for ideas on the nature and running of the NSF. We have the following ideas:

Nature

Due to the requirement for irregular contributions, the NSF must by nature be a defined contribution (DC) fund. However, as it is being offered by the State it can incorporate many beneficial elements of defined benefit (DB) funds. In essence the NSF can be both DC and DB if both the:

- returns and
- annuitisation

of the fund are defined. This will mean that at a specific age a contribution of A will result in a pension of B at NPA. More importantly, a defined return of CPIX[1] + x%, will define a pension relative to today's money. x% would have to be of the order of 3% to 4% per annum to be competitive with occupational pension funds.

Guaranteed annuitisation will not only bring the benefit of easier retirement planning but will also enhance benefits. It is commonly suspected that current market annuity rates are based on mortality that is significantly lighter than the population mortality at large. The NSF will therefore be able to offer larger pensions for the same amount of money. The problem of lighter female mortality will need to be addressed. Should annuity rates be gender neutral thereby giving females an advantage or should annuity rates take into account the significantly shorter expected lifetime in retirement[2] of males? A common solution used elsewhere in the world is to have a compulsory spouses pension, which can be designed to eliminate the differential. However this may discriminate against single pensioners and homosexual couples.

We thus recommend that different annuity rates be provided for depending on the marital status of the pensioner. This is consistent with NTTT view that pension benefits should have equal value (rather than equal starting pensions).

One problem with this approach is that persons with perceived/real lighter mortality may join/switch to the NSF prior to retirement so as to benefit from relatively better annuity rates.

Another possible option is for the NSF to remain a savings vehicle and that pensioners will draw from their accounts in a way similar to living annuities. The majority of the SSC felt though that the guaranteed nature of a pension would be of great value to the majority of members of the NSF. It was also felt that allowing the option of a guaranteed annuity or living annuity type savings account could lead to adverse mortality selection i.e. with those in poor health choosing the living annuity route.

Delivery

The State should offer a NSF vehicle in the first instance. Private NSF vehicles should be allowed under license, provided they can match the State's guaranteed return of CPIX +x%, net of costs. As say CPIX+3% may be easy to achieve for large contributions, this may encourage private providers to cherry-pick customers. This can be prevented, by making it a license condition that all customers be accepted. Various license holders would then compete on the basis offering CPIX + x% + Extra% guaranteed.

On retirement, the funds could be deposited back with the State NSF or the license holder could guarantee the annuity. This would again have to be an all or nothing choice, to prevent cherry picking.

If this route is followed, expenses could well be saved if the State NSF (or SARS, the UIF etc.) acted as a central collection point between employers/individuals on the one hand and the NSF license holders on the other. Thus each employer has only one transaction and each license holder has one transaction, rather than each employer having a potential transaction with each license holder. This is also likely to reduce fraud and make monitoring easier.

The State NSF's own funds could be tendered to third parties for asset management with a clear benchmark of CPIX +x% + y%. y% can then be used to fund expenses.

Our comments below could apply both to the State NSF and other licensed NSF vehicles (if this route is taken).

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[1] Or any other suitable index
[2] Even assuming the NPA is equalised between genders

Preservation

It seems a given that preservation will not be mandatory and that NSF funds may be used for needs other than retirement. Preservation can be encouraged, by offering a lower return on money withdrawn prior to NPA, perhaps CPIX+0%. An alternative, which may be easier to administer, would be to allow only say K% of the fund to be withdrawn in any year. A suitable value for K% may be 10%. K% may be allowed to be larger on certain life changing events such as retrenchment or the death of a spouse. The alternative proposed in the general ASSA paper of splitting the NSF fund into a 75% portion (compulsory preservation) and a 25% portion (allowed early withdrawals) is also supported by the SSC.

Transfer

It is envisaged that other retirement savings have the option of being transferred to the NSF. Since NSF benefits are envisaged to be tax free, this would mean SARS would require a tax on transfer.

NSF benefits on the death of a member should be able to be transferred to the NSF account of a beneficiary.

Taxation

For the reasons outlined in the discussion paper a TTE form of taxation is appropriate. The NTTT does envisage that the NSF be exempt from retirement fund's tax. This effectively makes the NSF TEE, which would be attractive to tax payers.

Alternatively, statements on interest earned would have to be issued to taxpayers each year, which may complicate tax planning. Given the high interest (income tax) exemptions this would affect only larger NSF accounts (or those with other interest income). If NSF "interest" is taxed, it should be taxed similarly to a typical retirement fund, which would obtain most of its returns from equities etc., which don't attract additional tax. Perhaps only a portion of NSF "interest" should be deemed taxable. The portion will to some extent determine the extent to which higher earners participate in the NSF. In essence these taxpayers would have to balance:

- guaranteed real returns and
- potential better annuities
- known charges (zero if NSF return are always net of expenses)

with

- likely lower real returns (equity type yielding of the order of inflation +6%)
- higher taxation (marginal rates on potentially the whole account versus RFT on a small proportion of the account)
- potentially variable (and unknown) charges

when choosing between the NSF and say an occupational scheme or other vehicle.