ACTUARIAL SOCIETY OF SOUTH AFRICA ("ASSA"): COMMENTS ON *RETIREMENT FUND REFORM – A DISCUSSION PAPER*, released in December 2004 by the National Treasury

Annexure 1: The South African Retirement Fund Landscape

2.4 Replacement Rates

ASSA generally applauds the use of replacement ratios to assess the reasonableness of current retirement provision. From a detail perspective, it is clear that there is a wide range of assumptions that can be used when doing such calculations.

The one observation we would make, is that our experience shows that salary increases are, when taking into account merit increases, more than 1% above inflation. Clearly a higher salary increase assumption would decrease the calculated replacement ratios. To counter that, one could motivate for higher investment return assumptions. The general observation that salary increases are usually more than 1% in excess of price inflation can, however, be important from a modeling perspective.

Annexure 2: Access, Compulsion, and Preservation

2 National Savings Fund

ASSA supports the creation of a National Savings Fund, if the product is a true pension fund with limited drawing rights, as proposed in this document. This would ensure access to a retirement savings vehicle for those currently excluded. The challenge would be to make it attractive enough to encourage such individuals to participate, to provide above average investment returns and make it cost-effective. In order to make it cost-effective, the design of the NSF should be as simple as possible.

On the other hand, it could be argued that this product will compete directly with the banks, and not the pension fund environment. To be competitive, it will have to be subsidised both with regard to costs and returns, because the inefficiency of size will be a major problem. The nature of the beast is that it is a type of national stokvel, because of the tontine bonus at the end. The tax advantage of the product could be a major problem for the banks, even at the higher income levels. It would be difficult to stop abuse, because of the "simplicity" requirements. Because it is a casual savings scheme in design, it should not be seen as an alternative for a properly run corporate pension fund where the low earning members are subsidised with regard to costs.

Even though it appears reasonable to provide incentives for staying until retirement, it may be unfair towards those leaving before retirement, especially if there is cross-subsidisation between early leavers and those staying until retirement.

It is essential that there must be similar tax treatment for the NSF and other retirement vehicles. If the NSF is exempt from retirement tax, and other vehicles not, then those just above the threshold for joining would be in a

worse position than those just under the threshold. This would clearly be unfair.

The proposed NSF appears not to offer life cover. This would mean that people who are below the threshold and currently in occupational schemes will be losing their death benefits if they move. These are normally the "poorer" lives, so it will be much more expensive to obtain cover on an individual basis. Even if group cover is offered to the NSF group, the average cost will most likely be higher than currently being paid in the occupational scheme.

Furthermore, the discussion document wants the risk benefits capped so that there is sufficient allocation to retirement benefits. In a country where the life expectancy is probably going to drop significantly, this does not seem to meet the need of the majority of people who are in such schemes.

3 Differentiation

ASSA endorses the following main principles propounded under the topic of differentiation:

- Harmonisation of the tax treatment of different retirement funding vehicles.

- The need to carefully differentiate between fair and unfair discrimination.

- Choice of fund being negotiable as part of an employee’s conditions of employment. (However, we add the caveat that this should be subject to the employer reserving the right to make membership of a particular fund compulsory for all employees in a qualifying category.)

- Allowing employers who wish to make “top hat”/special arrangements for their senior employees the freedom to do so through supplementary arrangements. We are of the opinion, however, that they should not be forced to do this by means of separate individual arrangements.

Consideration should also be given to allowing “top hat”or additional savings in the same fund for all members, which could include senior executives. The cost structure can be more efficient and the objective to have one pool per member is easier to attain.

3.1

Table 3.1 (p 21) gives a good description of the retirement funding arrangements that exist across the income spectrum in SA at present.

There are, however, some areas that require urgent attention. These include:

- A revision of the means test, so as not to disincentivise retirement savings.

- The need to remove the differentiation that exists between self-employed and other workers.

- A review of the current retirement funds tax dispensation, which may operate regressively by imposing a relatively higher tax burden on low earners than on high earners. We hope to deal with this issue in more detail when proposals for the tax regime of retirement funds are discussed.

3.2

The issue of what constitutes fair or unfair discrimination needs to be examined much more closely and made more explicit. This will require extensive consultation to ensure that prohibitions do not result in unintended undesirable consequences. The actuarial profession is well placed to give considerable input into an informed debate on fair and unfair discrimination practices. We also feel that proposals should be in line with the *Promotion of Equality and Prevention of Unfair Discrimination Act* and should not attempt to go beyond this.

The reasonability tests to determine fair discrimination should take the following into account:

- Impact on the financial soundness and sustainability of the funding arrangement.

- Impact on the employer's right to attract, retain and appropriately remunerate workers.

- Impact on member reasonable benefit expectations. For example, a commutation factor represents the present value of a member's future pension benefit expectation, which is therefore dependent on life expectancy. If it is recognised that retirement benefits are intended to meet a member's need for financial security, then the fact that females are statistically expected to live longer than males should be recognised as fair discrimination by any such reasonability test.

- Impact on the level of cross-subsidy. Retirement arrangements often incorporate a degree of cross-subsidy, but when these levels become excessive, accusations of inequity may be levelled by those disadvantaged.

3.4

Employers should not, however, be compelled also to offer external funds (e.g. open funds) that have not been negotiated with trade unions, bargaining councils, and the like. This would in all likelihood result in higher cost "individual fund" options being mis-sold to employees.

Where possible, legislation should encourage participation in vehicles that enable economies of scale and do not require high “distribution” or “marketing” expenses. This is, however, an ideal situation. If this legislation is promulgated, it may just end up with much lower take up of individual retirement provision and defeat the object of obtaining wider coverage. The fact of the matter is that if there is no compulsion, behavioural economics shows that people tend to spend money, rather than save for retirement.

It should also be recognised that if an employer’s workforce is “splintered” among too many funds, the costs of the smaller funds will be proportionately higher than if most employees were accommodated into one fund, albeit with differentiated benefits. In addition, the employer’s administration and communication of the various retirement options becomes more expensive and cumbersome.

3.5.2.1

In terms of differentiation on grounds of employment status, ASSA believes that it would not be appropriate for the State to interfere in the negotiation of remuneration between employers and employees. An employer may wish to attract a certain category of worker and should be free to provide such categories with differentiated employment benefits (which includes retirement fund benefits). The employment process is already substantially regulated via the *Labour Relations Act*.

3.5.2.2

ASSA disagrees with the proposal to force employees requiring special arrangements into expensive individual arrangements. This is considered unnecessary interference in the employment relationship and the freedom of parties in the employment process to negotiate the form of remuneration. Within any limits imposed by tax legislation on tax-favoured retirement savings, individuals should be free to operate group arrangements if these offer advantages (e.g. in terms of cost saving).

3.5.2.3

The implications of this section may be regarded as potentially dangerous and therefore need to be considered carefully. Unfortunately, this section is also somewhat vague and loosely worded, and is therefore difficult to interpret. We recommend that the intentions of this section are further expanded and clarified, including concrete examples of current practices that would be abolished if the proposals were implemented.

The suggestion that the value of benefits should not be allowed to be materially different, depending on the age of entry to the fund, is unsound. It would clearly be inappropriate to compel provision of the same present value of benefits to someone entering a fund at age 30, compared to someone who enters at age 50.

Much also depends on how one determines the present value of benefits. Does this mean that death benefits must (in expected value terms) equate to

retirement benefits, so as not to discriminate against members in very poor health? Trying to achieve material parity in expected value terms would be extremely complex, and in practice, impossible.

We are firmly of the view that the issues raised by this section should be investigated in much more depth, with wide-ranging consultation. Care must be taken to ensure that all proposals can be practically implemented, and that they do not lead to destructive anti-selection, which would destroy the principles underlying sustainable insurance and risk control.

3.5.3.1

ASSA agrees that members should have limited discretion. We emphasise that employers should be free to negotiate membership of particular funds as a condition of employment, or choose not to participate in a retirement funding arrangement, and not be compelled to offer a range of funds, unless this is specifically negotiated.

3.5.3.2

The proposals in this paragraph could be seen to be in conflict with the broad principles espoused in par 1.3 of the discussion document.

In order to promote retirement savings, it is suggested that while this category of employee be given the option to join the NSF, if he/she chooses not to do so, then he/she could be compelled to join an occupational retirement fund.

It should be noted that employer funds should also be compulsory for all staff to assist with the anti-selection problems (e.g. all such staff with a choice will have to go for medicals because of the anti-selection problem, and this will increase the risk of “social selection”). Housing assistance plans should include all employees and having them in one fund assists with the planning and equity of the scheme.

4 Individual Retirement Funds

In ASSA’s view, the individual retirement fund option is a good idea in theory. As long as the provisions of par 4.2.8 (dealing with commissions for intermediaries), together with no compulsion, are in place, however, there may only be a very limited take up. High earners will join, because they can afford to pay on a fee basis for advice, which may include joining a fund. The other side of the spectrum will be covered by the NSF. The large majority of people who do not join an occupational retirement fund and do not fall into this category will, however, not be catered for.

6.5

ASSA supports the principles espoused in this paragraph.

Annexure 3: Benefits, Contribution Rates and Member Protection

1 Adequacy of Retirement Benefit

ASSA supports the objective of ensuring a combination of social old age pension and formal retirement provision targeting a replacement ratio of around 75% of pre-retirement salary. Equally, the proposed amendment to the means test should encourage lower paid employees to make some private retirement provision.

It is, however, unrealistic to assume that members and employers will be able to afford contributions of 22.5% of salaries for retirement saving (i.e. net of death and disability premiums and administration expenses), commencing once the member attains age 40. Retirement savings must start at an earlier age, otherwise most employees will not attain the targeted replacement ratio. It should also be borne in mind that very few employees remain in employment until age 65.

Consideration of greater tax-deductibility of contributions with increasing age still has merit, however, as it will incentivise individuals to boost their retirement savings where affordable.

Although it is appreciated that the provision of housing and other necessities is fundamental and should receive priority at younger ages, the aim should be to encourage saving for retirement from as young an age as possible. The replacement ratios included in the report clearly indicate the benefit of starting the savings programme at an early age.

Having made the comments above, we also wish to draw attention to the fact that a replacement ratio, while being a good target that can work quite well in an occupational scheme where the employer can make additional contributions to top up pensions, can be a nightmare for DC schemes. It depends on actual returns, which for a particular member do not work on the quoted averages. It also depends on the terms available in the market on the particular date that the member retires. We very much doubt that traditional employee benefits consultants have thought about these issues as they affect individuals, rather than on a basis where the average of the group evens out over time. Unless members in DC schemes get adequate reports on their progress towards retirement, they will not be able to adjust their targets as their particular circumstances change.

2 Pension Increases

ASSA agrees that it is desirable for the purchasing power of pensions to be protected against inflation where possible and that the affordability of pension increases should be limited to the available pensioner assets in each fund.

The concept of a pension increase policy introduced in the *Pension Funds Second Amendment Act*, 2001, is only applicable, however, to defined benefit funds, as well as a few defined contribution funds that retain pensions in payment. Therefore, given the fact that most defined benefit funds have

converted to defined contribution arrangements, the comments contained in the report are not relevant to the majority of retirement funds and most pensions in payment.

However, in 2.1 of the discussion paper, the minimum pension increase provisions of the *Pension Funds Second Amendment Act* are described, with one comment referring to “ the lower of…. and the increase that the fund can afford based on the nett investment return earned on the assets backing the pensioner liabilities”. The problem is that this may have been the intention of the minimum pension increase wording in the Act but the reality is that the construction in the Act excludes the mortality profits from previous deaths and hence does not achieve the desired result. In many cases, we can see that investment returns would justify higher increases, but the minimum pension increase provisions do not require any such increase, even where inflationary increases have not been given in the past.

This could be why the reference is made to the implementation problems of the minimum pension increase provisions requiring address. However, it needs to be appreciated that if the minimum pension increase provisions in the Act are corrected, there will be additional liabilities created for funds – such a move will not be very popular if such funds have just distributed this as surplus.

The basic principle of determining the affordability of pension increases with regard to investment returns modified by longevity losses seems appropriate and this we support, but major practical problems are created by the fact that the current minimum pension increase provisions do not have this effect.

In respect of members retiring from defined contribution arrangements, the discussion paper does not deal adequately with the whole question of the provision of income during retirement. The only reference that can be found with regard to this topic is found in footnote 35, which indicates that “the risk is best left to a well capitalised and regulated insurance industry”. The remaining 77 pages of the document deal with the accumulation stage of retirement planning.

ASSA believes that the provision of suitable pensions in a defined contribution environment needs a great deal of attention. The spending stage of retirement provision is just as important as the accumulation stage and is almost unregulated at present. We believe that the development of adequate vehicles for retirement income provision, including a product for the NSF, is vital to the success of pension provision in South Africa.

We do not agree with the statement that retirement income should be left entirely in the hands of the insurance industry. The current absence of guidance post retirement does not support this objective. In addition, there is a dearth of inflation-linked bonds, driving down the returns on these assets due to the excess of demand over supply. This makes it very difficult for insurance companies to offer such benefits on an attractive basis.

Just as for the NSF, there may be some scope for a "central" low cost pension payment fund to which all retiring members can transfer their retirement capital. Again, we are of the opinion that this is a type of product that should be housed in the NSF if it is a properly run pension fund, and the subsidies will then extend to the pensioners as well.

The new Act should also consider the requirements of pensioner-only funds of which there are likely to be a number, given the conversion of the active members of funds to new defined contribution funds. Such pensioner-only funds do not conflict with the stated principles in the document to provide pensioners with the pensions and increases affordable from the separately invested pensioner assets.

2.4.2

This section suggests that pensioner assets are invested separately for the benefit of pensioners. This has the following possible disadvantages:

- Active member liabilities within a fund allow for a longer-term view with respect to investments. This in turn allows for the possibility of equity investments. In years of good market returns (such as 2004), the pensioners would benefit from a portion of this exposure, which is unlikely to be available if a pension asset strategy were chosen. The opposite does apply in that one could argue that the pensioners should not be affected in years of poor equity returns earned on "active member" assets.

- The separation of assets would imply a similar separation of liabilities. This then begs the question whether or not this closed group should bear its own expense and mortality risks, without any cross-subsidisation from the rest of the fund. In times of improving mortality, the pensioners may lose out from pension increases in line with benefit expectations if these are reduced to offset mortality losses within the closed group.

- The assets of a pension fund are indivisible. We suggest that proper matching strategies should be required instead. The proposal of dedicated assets needs to be modified, and perhaps dedicated, but not to an insurer's expense and profit margin.

3 Benefits Available from a Retirement Fund

All in all, ASSA is of the view that this is positive and appropriate. A few comments on detail follow below.

Paragraph 3.5 states that no minimum rates of contribution should be prescribed in legislation, whereas paragraph 3.4.1.2 states that the allocation of the total contribution rate between retirement savings, administration costs and insurance premiums should be disclosed to members. More should probably be done in this regard, as very few members would know what retirement benefit this would result in.

Projections on fund level (in other words, for a member entering at age *x* the expected replacement ratio based on the available contribution rate for retirement would be *y*) need to be given. This should be in addition to individual benefit statements.

3.4.1.4.

One of the main problems experienced currently is the onus placed on trustees in distributing death benefits to dependants. ASSA is of the belief that further research needs to be conducted into the introduction of an effective process for the distribution of death benefits. The process needs to be capable of reasonably simple application and yet allow the trustees some freedom in acting in the best interests of dependants.

3.5 Minimum Rates of Contribution

ASSA wishes to raise the issue of funds being registered where, for example, the members pay 2,5% and the employer 4%. Such funds should not be called pension funds, but savings schemes, because of the deficient contribution level. Members are lured into believing they have a proper fund if it is called a pension fund, and then may discover too late that they are in financial trouble.

3.7 Form of Benefit Payment

ASSA supports the principle of limiting the amount that a member may take in cash on retirement. An important reason for this limitation that is not covered in the document is that for many, if not most, retiring members the pension that can be purchased with their full retirement benefit is considerably less than their pre-retirement income. Allowing a large portion of the pension to be commuted further reduces the replacement ratio.

The amount that may be taken in cash should be integrated with any revised basis for the taxation of such lump sum payments.

An option which merits consideration within both formal retirement funds and the NSF is for defined contribution funds to split the contributions for each member on, say, a 75% / 25% basis (or some other prescribed ratio). Members would be able to access the balance in the 25% account during employment for housing or life-crisis needs. Any balance in the 25% account could be taken in cash on retirement or on earlier exit from employment. The full balance in the 75% account must be preserved on change of employment or paid in the form of a pension on retirement. This approach would address several objectives of the National Treasury document:

- Limited access to lump sums on retirement;
- Reasonable preservation of benefits on exit from employment;
- Some level of access to retirement savings for housing, life-crises and for support during periods of unemployment, and

- Reduced leakage from funds.

This proposal will involve an increase in the cost of administration of funds, but is likely to be a lot simpler to administer, easier for members to understand and easier to regulate than alternatives that try to ensure some level of preservation and that limit lump sums on retirement. Careful consideration would need to be given to the taxation of withdrawals from the 25% account. Both the administration and tax issues should not be insurmountable.

Some recognition should be given to the accrued rights of members to take lump sum benefits, i.e. there should be some transition arrangement or formula to allow people close to retirement to take provident fund benefits in respect of service up to the inception date of the revised Act as a lump sum.

Consideration should also be given to whether married members, using a broad definition of marriage, should be compelled to purchase a pension which on their death provides a pension to their spouse.

ASSA is of the opinion that the splitting of accounts on divorce could pose an interesting challenge. The 25% level for cash is deemed to be a pressure point, and future innovation will most likely increase the level. Pensions that do not provide a contingent pension to the spouse are as deficient as a level pension.

3.8 Post Retirement Medical Funding

ASSA supports the principle of allowing the funding of post-retirement medical aid benefits within the retirement fund arena. The motivation for this is that the same rationale as to pre-funding retirement benefits applies to medical aid contributions, i.e. to build up during employment sufficient funds to pay for expenditure after retirement.

ASSA would, however, note the following:

- Members as well as employers should be allowed to contribute towards the funding of post-retirement medical contributions.

- Specific and possibly separate tax treatment of these contributions will be necessary to incentivise such saving.

- The amounts need not be held in an Employer Surplus Account (except in the case of existing liabilities), but could equally well be held in specific defined contribution accounts on behalf of members.

- We disagree with the statement in 3.8.4.1 that members should accrue no rights to the accrued benefit unless they retire from the service of the employer. Ideally, the benefit should be portable and transferred out on the exit of the member – just as with retirement savings, members should accrue post retirement medical contribution savings in

respect of any period of contributory service they have with an employer.

3.9 Leakage

ASSA agrees with the statement that the primary cause of inadequate retirement benefits in the formal sector is the leakage of benefits before retirement. Compulsory preservation of all or the majority of member benefits on early exit from employment is supported, although recognition must also be given to those people who cannot secure alternative employment and instead rely on their accrued retirement savings for support.

We again note that the suggested structure of the NSF (allowing withdrawals) and the proposal to allow members currently in formal retirement arrangements who are below the tax threshold to transfer their benefits to the NSF are very likely to lead to massive leakage. We again recommend that these provisions be reconsidered and suggest that the tax system be instead reviewed, so as to make it tax efficient for lower paid employees to remain in the retirement fund net.

3.10 Minimum Benefits

ASSA supports the position that the principle of minimum benefits is maintained in the new Act, especially given the commitment to resolve the drafting and implementation difficulties with the current definition of minimum benefit.

3.11 Loss of Employment

ASSA agrees with the principles suggested, but with the following provisos and comments:

3.11.3

The issue of a person only unemployed for a short period of time must be considered. Granting an extended monthly income equal to the UIF could be a consideration for, say, the balance of the 12 months following the loss of a job and thereafter a proportional lump sum and an income flow could be made available to the individual, funded by his/her retirement savings. Such a “loss of job” benefit must be designed to be similar to the retirement benefits that will emerge from the system. Moonlighting to access the retirement savings must be penalised to maintain the integrity of the system.

3.12 Preservation and Portability

The choice of funds could be a complicating factor with no incentive.

3.12.3.1

Transferring to the new occupational fund is the first choice, because the problems with losing contact with the employee is created by the lack of contact if he/she is not connected to the fund by the payment of contributions by the member or on his/her behalf. The other options should be discouraged to simplify the system for all. The problem of advising the member is a crucial problem in this process.

3.12.3.2

The reasonable notice should be that when a person resigns, the employer is advised and he/she must inform the occupational fund immediately. The person must also inform the employer/fund whether he/she has a new job or not. Should he/she then have a job, the fund must identify whether such an employer has a fund and the moneys should be transferred there as soon as possible. The section 14 procedures must be simplified to speed up the transfer. Should the member be allowed and elect to go to an alternative individual fund, he/she should do so before the final date of leaving employment with the previous employer.

3.12.3.3

The transfer should rather be to the new fund as the first option, with a final default of an individual retirement fund if the new employer does not have a fund. Individual funds tend to have minima that are there for practical reasons. This is not normally the case with occupational funds, because the member is continuing to contribute to the savings pool.

Subsequent moving of such investments between individual pools is again a problem if no fees are to be deducted from the member's pool. If the member does not pay, it means that the other members who stay in the pool must pay for those members moving between the different pools, which is unfair. A reasonable switching charge by the administrator must be allowed.

3.12.3.4

This is another interesting point. The costs associated with transferring or receiving moneys should be paid by somebody and again the fairest solution is that a reasonable deduction be made from the transferred amount, otherwise the existing members in the pool will have to pay the costs of the transfer or accommodating new members in the pool. Such costs are generally increased for exits and reduced as an incentive to obtain new members, but then the existing members must be aware that they are paying for this, and it would then be deducted from the running costs of the scheme.

3.12.3.5

This is a critical point for all parties to debate carefully. Does this imply that the member him-/herself may not pay anybody for advice because he/she is a

party to the transaction? Would the employer and the fund be in the same position, or not?

Members need advice if they are given an option to transfer to alternative funds. With no fees, no advice will be available, other than from the FSB or the employer, and such advice could be questioned if professionally assessed. Who pays for the potential of "bad" advice from either of the above parties?

The member will thus have to rely on the one party with an incentive to obtain the business, i.e. the individual administrators. Where they have established a relationship with an employer, the advice given will attempt to drive the member into that fund. Should the employer be large enough, they could establish their own individual funds as a business opportunity. This is already a reality in the South African market. The question then arises as to the capability of such an administrator to provide "independent" advice in the interest of the member.

Alternatively, the advice must be given by the FSB. They will thus become an advisory party to the public at large and will have to employ the expertise to compete with the independent institutions that traditionally provided this advice. The FSB clearly has an incentive to become a competitor in the financial industry. In that case, another controlling body should be established to monitor the advice given by the FSB.

The proposals are therefore structured to assist certain industry groups if no advice may be paid for.

3.12.3.6

(a)

Should such a minimum be allowed, consideration should be given to allowing it for all transfers, i.e. that a small amount be allowed as cash in all cases. This will stop people resigning to access the cash and running the risk of losing their jobs. In addition, the problem created by small casual loans by employers for funerals and other purposes should be addressed by the Task Team. The alternative to a minimum amount is to have a minimum period of membership within which cash benefits are paid - e.g. in UK it is 2 years.

(b)

The default after settling a housing loan should be the same as under 3.12.3.1 to keep the administration simple.

3.13.2

The intention is fine but to be fair, the cost of administration should be deducted. Consideration should be given to whether late payment interest is payable on the tax and possible housing loan portions as well, or only on the net benefit payable.

3.14.1

The problem of unclaimed amounts should also be minimised for the future, and the procedures suggested in 13.12 will assist in minimising such cases in the future. This should be a first priority.

The problem that is created by criminal cases, divorce allocations and casual loans by employers to members must also be regulated, as is the case today. Although it is not the ideal situation, the practical issue of casual loans which are made to assist employees at low income levels could be facilitated by allowing the cash-out portion (if allowed) to be used as security for such purposes.

3.14.2

ASSA agrees with this, but then the State should guarantee that all such transferred amounts will be paid to members and/or their dependants if they subsequently claim. This seems fair as it is envisaged that the State will be the beneficiary of the unclaimed amounts.

3.14.3.1

ASSA views this as a fine recommendation, because it will simplify retirement funds in this regard. Interest less cost should also be transferred. The Transferor fund will have to keep a record of such transfers because the member or his dependants will tend to come back to the employer/fund for assistance. These records may have to be kept for a prescribed period, and should also be subject to section 14 and audit controls.

3.14.3.2

The central fund must also have a discipline in terms of how much money can be spent on searching for a beneficiary, unless the State will fund the costs. The benefits from such a fund must preferably be spelled out so that members are not disappointed at receiving small amounts after deducting the cost of the search. This should include the envisaged interest and expense allowances of such a fund.

There is considerable onus placed on the “unclaimed benefits fund” in this recommendation. In many instances, the benefit available to the untraced members is insufficient to cover basic tracing costs.

3.14.3.3

This is fine if the warranty in 3.14.3.1.is provided.

3.14.3.4

This should be a compulsory payment and the word “may” should be changed to “must” or “shall”.

3.15

ASSA supports the restriction of new housing finance to guarantees, which avoids funds engaging in housing finance business and potential misallocation of resources.

It is not clear to us, however, why such guarantees should be limited to low income earners and fixed Rand amounts. Many employees have benefited from such arrangements, which can save legal and administrative costs, without negatively impacting on their funds' net investment returns or risks. Such arrangements would therefore appear to be in the public interest and we would prefer to see restrictions focused on the avoidance of negative impact to any of the membership of a fund involved with such a guarantee arrangement, rather than limiting the potential beneficiaries.

Since interest earned within a fund would normally be expected to exceed interest payable on a secured bond, 3.15.1.4(b) appears to permit guarantees of loans under which no repayments are made, but which would be expected to be covered by the net retirement benefit. Such arrangements would not only lead to almost all the benefits at retirement being in the form of a residence but would also expose members to a real risk of default if fund returns are lower than expected. We therefore believe the terms of the loan should require payment of the full interest and at least a portion of the capital.

If, on the other hand, these proposals relate to the portion available in cash, however, we are of the view that paying off a bond after retirement is not improper, and the risk is transferred to the institution. In this instance, the settlement of housing debt from the retirement savings should be limited to the cash portion, otherwise abuse via housing schemes may flourish.

ASSA supports the principles in this section but there must be real danger that 13.15.2.3(b) will lead to most contributors withdrawing their savings prior to retirement – although exemption from the means test should help.

Payment of an enhanced rate of interest will effectively lead to a bonus payment on retirement. Such a bonus must be either be paid out of interest earned on the NSF assets or monies must be injected into the NSF by the State. The former method would effectively penalise early leavers and appears to run counter to the spirit of minimum benefits – as prescribed in the *Pension Funds Second Amendment Act*, 2001.

3.15.2.3(b)

Given the current minimum benefit environment, members are entitled to employee and employer contributions with interest, regardless of their mode of exit from the Fund. Is this section implying that a penalty could be applied if savings are withdrawn as a result of life crisis needs?

3.16 Deductions

Removing the ability to deduct the amounts due to the employer due to damages, theft etc (3.16.2) is admirable but should only apply in the event of

a member's death, in other words the beneficiaries should not suffer as a result. However, if the member resigns, is dismissed or retires, the ability to deduct should remain.

The rationale for this is as follows: if the pension benefit is protected, the only recourse for the employer is to the member's estate. However, what if the member receives the benefit and invests it, or uses it to create additional wealth? Will this be similarly protected? In other words, within the estate, is there going to be protection offered to the original proceeds from the fund? Alternatively, is there a cut-off period when the benefit is now deemed to be part of the estate, when previously it was pension benefits? It becomes very complicated and therefore makes sense to allow the deduction at the time of exit, so as to avoid the additional costs and hassle of trying to recoup the money at a later stage. However, as outlined above, in the event of death the beneficiaries should not be liable for the member's debts.

Consideration should also be given to the position of the SA Revenue Service with regard to outstanding tax.

The deduction of medical scheme contributions and insurance premiums (3.16.3) usually only applies to a pensioner in receipt of a pension from the scheme. This is usually an administrative convenience for the pensioner and more cost effective than paying the bank charges for a debit order, or if a pensioner does not have access to sophisticated banking services, but does receive a medical subsidy, for example. These deductions should not be forbidden, but allowed on the written request of the pensioner. However, such deductions should not be automatically applied or compelled by the employer or trustees. The member may be offered the facility, which they either accept or decline. A similar principle should apply to any other deduction which the member wishes to make from their benefit and which the trustees are willing to facilitate through the administration system.

Furthermore, it is not clear why housing loans or guarantees are given preferential treatment (3.16.5.1). The same principles as outlined in par 3.16.3 regarding priority claims would apply equally to the bank offering the housing loan and to the medical scheme. It is similarly in the best public interest for members to be covered by medical schemes as it is for them to be housed. Therefore, the distinction between the two types of deductions is anomalous.

The principle regarding the fact that additional voluntary contributions should not be offered the same protection as main fund benefits is contradictory (3.16.4 and 3.16.5.2). It is understandable that if the proposal by the Treasury is accepted, it could be open to abuse, but on the other hand, these benefits are similarly part of the retirement "package" and should be afforded the same protection. If the principles as proposed above regarding not allowing the deductions for deaths, but keeping it in force for other forms of exit, are adhered to, it is not necessary to make this distinction.

In addition, in the event of death, the additional voluntary contributions should not be paid to the estate (3.16.5.2), but form part of the ordinary fund benefits to be distributed in terms of Section 37C of the Act (as amended).

For further comments under 3.16.5.2 and 3.16.5.3, see also comments made regarding 3.18. Similar principles must apply regarding the application of the member's will and/or beneficiary nomination form.

3.17 Divorce

ASSA welcomes the proposals put forward in this section. This system will be a vast improvement on the current one. There is a small concern regarding the administrative issues: who is going to pay for the non-member spouse to remain in the fund – the employer, the member, the fund, or the non-member spouse? It may be preferable to compel the ex-spouse to take the benefit to his/her own fund.

If the benefit is left in the fund, will the spouse be compelled to take the benefit at the same time as the member exits? Could the spouse leave their portion of the benefit in the fund after the main member has left? How does this impact on unclaimed benefits legislation?

Furthermore, no mention is made of the tax implications, which are fairly complicated. On final exit from the fund, in whose capacity is the benefit taxed? What about tax-free portions that would otherwise apply, e.g. at retirement? Does the non-member spouse get credited with proportionate service to determine their tax-free portion? Or is the benefit fully taxable in the hands of the spouse? How does it affect the tax-free portion the member would get; is it reduced proportionately or left unchanged? The system could again be open to abuse, e.g. get a "friendly divorce" and transfer the benefit to the spouse who has a lower marginal tax rate, get remarried and have the full benefit out and pay less tax.

Finally, what is the position if the member is in receipt of a monthly pension from the fund? On what basis is the value of the spouse's benefit determined, i.e. on the member's or the spouse's mortality assumption? How does the contingent spouse's benefit affect the calculation, i.e. if the member is now single, is there no spouse's benefit? There could also be anti-selection, i.e. to divorce and transfer the benefit to another fund which is performing better, or even get a lump sum if that is permissible.

3.18 Payment of Benefits on Death

There are a number of problems with the current arrangement whereby the management board of a fund is responsible for establishing how moneys are distributed amongst beneficiaries and dependants of deceased members.

Given the number of deaths within certain funds, the funds have been required to set up specific committees to deal with the above distribution of moneys. This approach, whilst favourable from a social responsibility perspective, is time consuming – often leaving dependants without any source of income while disputes are being settled.

3.18.3.1(a)

Whilst this recommendation will assist, this may still not be sufficient.

In many cases, the nominated dependant may have died shortly before the main member. In this case, five years is too long to establish this prior to death. Members should be encouraged to review their nomination forms on a more regular basis. If possible, the employer should encourage the employees to notify the fund of any family changes.

In practice, review of nomination forms is inordinately difficult sometimes. People do not fill in forms correctly and to ask them to review it is naïve if they do not even complete the forms properly in the first place. Such forms will become legally enforceable if they confer rights on nominees and this will make the task of trustees more difficult.

3.18.3.1(b)

The management board is required to use its discretion in certain instances. Due to this being an onerous task, in many cases affecting the livelihood of a number of individuals, the board is required to take all reasonable steps to ensure that the decision made is fair to all parties. This again takes time – creating difficulties for beneficiaries who are in desperate need of the financial assistance.

3.18.3.3

The creation of trusts is also time-consuming. In addition, it is subject to challenge by beneficiaries who argue that they are capable of managing their own finances. The Adjudicator tends to support this argument – often quite rightly.

3.19.3.1

The payment of temporary and permanent disability benefits should be consistent with the "package" option discussed in Annexure 3, 3.1.2. In other words, this benefit should not influence retirement funding. With this in mind, the following should be considered:

- Will the benefit payable include employee contributions to the fund? In this case, the fund would deduct this payment from the benefit before paying the member.

- Will the employer be required to continue to contribute to the fund in respect of the disabled member? He/She should, so that retirement funding is not prejudiced.

- The employer may argue that his/her liability in respect of an employee has ceased following permanent disability. In this case, the fund should deduct a notional employer contribution from the disability benefit payment as a funding towards normal retirement benefits. This would again ensure that retirement funding is not prejudiced.

- The permanent disability benefit should be considered relative to ill-health pensions currently payable by a number of funds. These benefits should be consistent as far as possible. In other words, an individual in receipt of a permanent disability benefit should receive a similar benefit to an ill-health pensioner upon reaching normal retirement age, and *visa versa*.

Annexure 4: Governance and Regulation

1. Powers of the Regulator

As ASSA sees it, in a nutshell, the proposal is:

- For the regulation around State and State enterprise funds to be increased;
- for the enforcement powers of the Registrar to be increased (amongst funds and providers);
- to outsource some of the regulator's functions to external licensed practitioners;
- for the regulator to be separate from the FSB;
- to oblige the regulator to adopt a risk based approach to regulation, and
- for the regulator to promote education amongst members and formulate codes of good practice.

Whilst there could be some practical difficulties and cost implications in implementing these proposals, we do not believe that these would be insurmountable. We furthermore believe that the intention behind the proposals in this section is sound and good. We therefore support these proposals.

We believe, however, that it would be appropriate to express a measure of concern about the envisaged powers of the Regulator. Should the Regulator make a mistake, the affected party must be compensated by the State. For example, actuaries should only be barred from practising if ASSA supports such a decision. (The appointment as valuators is different and enshrined in law.) Should the license of an employer of, e.g., ABC Actuarial Consultants be revoked, who will pay the losses to ABC's shareholders if the courts overrule the Regulator? Furthermore, will ABC be barred from doing its consulting, actuarial and administration work while the court proceedings are going on?

2. Statistical Reporting by Funds

2.2

ASSA agrees in principle, but wishes to express a concern that over-onerous requirements with consequent costs will ultimately reflect on the members' benefits.

3. Member Protection

3.1

ASSA has no detailed comment to offer, other than that the asset-structure of defined contribution funds may need monitoring as a sub-point of 3.1.3

3.4

While ASSA agrees with thorough disclosure, the concern of over-onerous requirements resulting in higher costs is again pointed out.

In particular, the implication that information may be needed more frequently than annually is rejected. If this is to be allowed, appropriate fees should be charged to the relevant member to protect the other members of the fund.

The question arises whether the portion of contributions that were used to pay for administrative expenses should be expressed as a percentage or in rand amounts. The latter would be more expensive and may require the setting up of systems.

There are cross-subsidies implicit in administrative and, particularly, risk costs that may be difficult to unravel in practice. A certain degree of cross-subsidy is usually regarded as favourable.

Another question is whether investment returns are to be gross or net of investment management charges. The former may not easily be available.

Clarification should be obtained on whether members are to be shown the smoothed or underlying returns, in cases where there is smoothing of investment returns. Since it will be difficult to apply this to smoothed insurance products, provision should be made for the declared bonuses to be shown.

4. Dispute Resolution

4.4

It is not clear whether the specialist tribunal would have enough skills between them to cover the various dispute areas mentioned in 4.3.

5. Governance and Trustee Conduct

ASSA agrees with the sentiment and aims of this section. There are, however, a few points of detail that may require further consideration. These are set out below.

5.6.7

There is a danger that employers and employees may agree on an issue which has legal, but negative, consequences for pensioners or deferred

pensioners, or even individual members. Trustees are required to consider all proposed rule amendments in good faith, and ASSA deems this to be sufficient.

5.6.20.2

It is not clear why this restriction would be required. ASSA is of the opinion that the number should be determined according to the abilities of the umbrella fund.

5.6.21.1

A cooling off period may have the consequence that the trustees invest the members contributions in cash for the period, to avoid loss. This may be suboptimal.

5.6.21.2

Transferors should preferably pay for the expenses that they create by transferring and not be subsidised by the members who do not transfer, and limitation of such cost by legislation will imply that other members must pay the cost.

6. Intersection of Labour Law and Pensions Law

ASSA agrees with the view that the security of retirement provision has increased over the last 100 years from insecure retirement promises on a pay as you go system, dependent on the goodwill of the employer, to arrangements where the accrued benefits (i.e. benefits promised to a member in terms of the benefit structure of the fund) are funded and paid for as and when the service is provided to the employer. From a security point of view, it is essential that any such pre-funding be set up separate from the employer.

Historically, pension funds were under the control of the employer, as most of these arrangements (on a defined benefit basis) were the ultimate responsibility of the employer in terms of the employer being responsible to fund the balance of cost.

It would be incorrect to insinuate that most employers abused the assets under their control, but it can be argued that increased transparency and the involvement of member-elected trustees in their own retirement funding arrangements have contributed to the improved financial security of benefits to members. On the other side, ASSA agrees with the statement that employers may possibly face the financial consequences of funds where they have limited control. However, the assessment of financial risk should form an important part in the employer's risk assessment and corporate governance.

We agree with the statement that it may be difficult for the purchaser of an enterprise to replicate the defined benefit arrangement of employees being transferred. The suitable application of actuarial practice, together with the application of economic assumptions based on market conditions (required in terms of such statutory valuations as per PF Circular 117), will, however, go a

long way to enable stakeholders to calculate the accrued benefit promises to members. It may be difficult to replicate the existing benefit structure in a cost effective way in a lot of cases. Section 197 of the *Labour Relations Act* does provide some guidance in respect of transfers of ongoing business.

ASSA agrees that in a lot of cases the interpretation of providing a similar arrangement is not necessarily an identical arrangement to that which employers enjoyed before, but is perhaps seen in a broader sense where the cost of providing benefits under the new arrangement is similar to that of the previous arrangement.

Given the business pressure and other factors facing any business that operates to generate a profit, it is extremely difficult to guarantee anyone employment over the medium to long term. The minimum individual reserve as defined in the *Pension Funds Act* does provide some guidance in terms of the minimum entitlement to a member on transfer or on conversion to a defined contribution arrangement, but the proper application of actuarial principles and best estimate assumptions (based on factors dictated by the investment markets) may at times lead to the market value of the benefit promise being in excess of the minimum legislated benefit.

The comparison of expected benefits at retirement on any conversion is a more contentious issue. On the one side, one may have a group of employees feeling pressured that their continued employment is in some way dependent on the conversion to a less expensive retirement arrangement, and they would be unwilling to accept any change in the conditions of employment, whereas the employer may be unwilling to provide an indefinite guarantee of (possibly expensive) future retirement benefits, guaranteed until the eventual retirement of all members. A solution is, in our view, to provide for members to accept any transfer on a voluntary basis. The setting of a contribution rate for an individual member to ensure that the benefit at retirement is expected to be similar on appropriate assumptions is not out of place and is similar to provisions in the United Kingdom.

We agree with the statement that the employer should make good any shortfall on the liquidation of a fund in terms of minimum/accrued benefits, unless exceptional circumstances like a material breach by the fund's trustees or service providers are responsible for such a shortfall. The additional provision that the employer may get away with the financial burden of a shortfall in cases where future employment of members is threatened, and/or the company, will require careful consideration, but this seems to be contemplated in the document as approval from the regulator is required.

The setting up of a separate set of accounts for pensioners within the pension fund may not be universally accepted by actuaries. This is akin to operating a pensioner portfolio on a defined contribution basis, whereby the pension payments together with future increases are managed in such a way as to ensure that the last assets in the pensioner portfolio are paid out in the month of death of the last pensioner. However, without the employer as a guarantor in terms of maintaining the purchasing power of pensions, this may expose pensioners to some inflation risk or risk investments in order to maximise increases to pensioners. This behaviour may be limited by appropriate

regulation in respect of setting up an appropriate investment strategy in respect of pensioners.

On the other hand, the fund can be seen as a single entity with the assets in the fund providing the benefits promised to pensioners, as well as non-retired members, and with the employer underwriting minimum legislation benefits to members and pensioners. The million dollar question is: would a pensioner rather settle for a pension underwritten to some degree by the employer aiming to keep up with inflation (but no more) or face the potential investment risk of lower than inflation increases together with the upside of good investment returns? Without an employer underwriting any pensioner pool, the pensioners may also find that in the longer term the increased life expectancy of pensioners erodes their pensions as their original cost estimate of their pensions proves to be insufficient.

ASSA agrees with the comment that any reduction in benefits should be subject to the applications in terms of employment law with regard to the changes of conditions of employment. This would in our view remain within the ambit of labour law that governs the entire relationship between employer and employee.

Finally, more regulations may be required in terms of the interpretation in respect of members' reasonable expectations. In respect of vested promises, the balance of power should remain with members and pensioners who are the beneficiaries of benefit promises made by their employer in respect of whom they have performed the services as required by the employer. However, the right of members in respect of benefits for future service will be contentious. For example, it would be difficult to reconcile the guarantee of future service benefits to employees in respect of services not rendered with other areas of labour legislation, where the member may be retrenched and is not guaranteed employment until retirement.

7. Investment Regulation

This paragraph principally deals with four issues, namely:

- Investment regulation in terms of the draft Regulation 28 of the Pension Funds Act;
- Shareholder activism;
- Socially responsible investing (SRI), and
- Member investment choice.

In ASSA's view, the general principles detailed in this section are to be commended as they:

- Provide a reasonable framework (subject to further detail being provided – see below) within which trustees can implement an investment strategy;

- allow funds that have a higher governance budget to implement more complex strategies, which may increase the prospects for superior long term returns;

- do not impose SRI on retirement funds, but creates a reasonable framework within which funds can adopt such a strategy, and

- aim to protect member interests.

Regulation 28

The approach adopted is a combination of the “prudent expert” measure and certain quantitative measures. The quantitative measures are designed to provide a framework for smaller funds that probably cannot afford to source expert advice.

The quantitative measures are maxima on investments in participating employers, any single investment and investments outside the RSA. The restrictions on investments in participating employers and single investments are sensible.

It will be interesting to see at what level the maxima for offshore investments is set. This needs to be a reasonably high level to reflect the benefits of diversification and the principle that an appropriate investment strategy should be based on the total wealth of the member as opposed to just his/her retirement fund assets. These factors provide a significant offset to the standard argument that SA assets should match SA liabilities.

Standard prudential limits will be set for various asset classes for those funds where the trustees are unable to devise and implement a “prudent expert” investment strategy.

ASSA believes that this is good idea, although it is going to be complex to set these limits in such a way that the strategy is consistent with the underlying nature and term of the liabilities. Quite a bit of work will be required here.

The “prudent expert” measures are that there will be no prohibitions on investments in any particular asset class, provided that the trustees can demonstrate that this is consistent with the nature and term of the liabilities etc.

Again, ASSA is of the opinion that this is a good provision, but the obvious risk is that smart advisors may lure the trustees into complex investment products that they do not fully understand. The regulator should probably have some system to identify investment strategies that are unusual and look for more evidence from the trustees that they fully understand these strategies.

A fund can apply for exemption from the prudential asset class restrictions referred to above if it:

- Takes expert advice in developing the strategy;
- obtains certification from the Fund's valuator that the strategy appropriate in relation to the Fund's liabilities;
- informs the membership of the strategy;
- implements the stated strategy;
- monitors compliance;
- reviews the strategy at least once a year; and/or
- reports to the regulator on compliance with the strategy.

The better governed funds would comply with these requirements.

The discussion document suggests that the Regulator be required to set benchmarks against which the performance of the asset managers can be monitored. This is not an easy task, particularly for some of the more complex strategies. The risk is that investment managers and funds then "herd" around these benchmarks, which defeats one of the aims of the new dispensation (i.e. to adopt more bespoken strategies).

The best approach may be to set some straightforward benchmarks (i.e. market capitalisation ones) at the quantitative level, but prudent expert funds should state their benchmarks when applying for exemption. Monitoring relative to benchmarks set by the trustees should be fine, and discussions at industry level as to appropriate benchmarks should lead to trustees making reasonable benchmark decisions. For the FSB to become the benchmark setting agency is, in ASSA's view, unnecessary.

Shareholder Activism

In our opinion the discussion paper adopts a good approach by simply stating that shareholder activism should be encouraged. As the owners of capital, members should be satisfied that this capital is being allocated appropriately.

Shareholder activism is an extremely complex subject and needs time to develop. ASSA would be opposed to a system that requires the trustees to exercise the vote directly.

Socially Responsible Investing

The discussion paper does not impose SRI, but correctly makes the case that SRI can constitute high returning investment.

ASSA assumes that implicit in the paper is an understanding that there are a limited number of SRI opportunities and any legislatively imposed minimum investment in this strategy would lead to market mispricing.

Funds are permitted, after having informed the membership and the employer accordingly, to invest up to 10% of their assets in SRI initiatives that are expected to deliver a return of at least inflation.

Although the intention here is good, it may have the undesired consequence that trustees avoid SRI because the return is expected to be only equal to inflation (and members have been informed accordingly). Some of the SRI will be close to private equity/venture capital, where the risk of a poor return (and correspondingly a high return) is increased. The return objectives of such a type investment must preferably emerge from the evolving competitive market.

Member Investment Choice

The discussion paper sets out the requirements that must be met if a fund is to offer investment choice. ASSA is of the view these are sensible requirements (which any properly governed fund would comply with easily).

We agree that choice should be limited. We would suggest a maximum of 5 options, as this should provide sufficient scope to meet the needs of almost all members. The average number of options in the USA 401(k) plans is 5. However, there may be specific cases – e.g. funds with more sophisticated members – where greater choice may be appropriate. This should be allowed if properly motivated.

8. Funding and Calculation Techniques

8.4.3

The discussion paper recommends that an actuarial review committee be established, and makes proposals regarding the composition and tasks of this review committee.

ASSA would respectfully submit that it is somewhat naïve to believe that administration of funds are such that actuarial overview is not necessary. Experience has shown that, without fail, where actuaries have been involved in data verification of DC funds, they could add value. This is irrespective of size of the fund. The conversion of lump sums to pensions and vice versa requires actuarial opinion. The accounting profession can deal with the asset side of the balance sheet, but, we submit, not the liability side. Footnote 52 (p 68), indicating that a “suitable person” should compare the asset to liabilities every year, should be revised to say that an actuary has to do it. The form can be short, but the experienced eye of an actuary is necessary.

ASSA is of the opinion that such the regulatory body envisaged in this section should fall under ASSA's own guidance, and not the Regulator’s. With regard to the “surplus” legislation (*Pension Funds Second Amendment Act*, 2001), we have noticed that trustees are getting involved with a lot of self-interest in the valuation bases. Everything must be peer reviewed to attempt to get a better valuation result, with concomitant costs.