THE BANKING COUNCIL

South Africa

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RETIREMENT FUND REFORM

Submission to National Treasury

1. Introduction

The Banking Council welcomes the release, for comment, of the report on Retirement Funding Reform. Furthermore, the Banking Council commends National Treasury on the depth and incisiveness of the thought process that went into the formulation of their recommendations.

We would like to endorse the overall objectives of Government relating to retirement policy and share the concern expressed by National Treasury that:

> *"For too many people, the build-up of savings is disrupted or the costs associated with retirement fund provisioning are unacceptably high. Between the basic old age social grant, on the one hand, and private contractual and voluntary savings vehicles on the other, there is a notable lack of cost-efficient vehicles appropriate to meeting the retirement funding needs of lower and middle income people, and those whose lifetime earnings are largely informal or irregular."*

It is in this gap in the retirement funding process that we believe South African Banks can make a positive contribution.

2. A National Savings Fund

The Banking Council had previously identified the dilemma facing many South Africans who have irregular incomes, are employed in the informal sector and who face life crises from time to time, but have no viable option to provide financially for their old age within the rigid structures of formal pension schemes. The proposal by National Treasury to legislatively facilitate the introduction of "a National Savings Fund" should provide significant relief to those facing the dilemma described above. It is mainly in the area of the details of the construction and operation of the proposed "National Savings Fund" that we would like to concentrate our comment.

3. The basis of a National Savings Fund.

3.1 As indicated in the report, up to 50% of the economically active population are either employed in the informal sector or have irregular incomes, at best. It is this section of the population that would be best served through a retirement savings product that has sufficient flexibility to cater for irregular contributions and life crises.

There are various ways in which a "National Savings Fund" can be constructed, but it is important that a number of basic principles are embedded in the construction process.

3.2 Firstly, the National Savings Fund could be a Government fund, and private sector institutions could, as agents for the Government, mobilise investments into that fund. Or the National Savings Fund could be a retirement savings product, nationally branded and with standard features, which is sold to the market by registered financial institutions on a competitive basis.

Past experience has been that the competitive energies of the private sector are not released by the former proposition, nor are they released by the private sector selling a standard product with standard pricing. But they are released by the private sector selling, for its own account, a product with minimum standard features, but with competitive pricing. This has been very clearly demonstrated in the launch of the Mzansi savings account (over 600,000 new accounts opened in less than four months).

Not only would such a nationally branded product with minimum standards, but competitive pricing, unleash the competitive energy of the private sector, it would also utilize the existing infrastructure within the banking system and so derive the resulting economies of scale.

3.3 Secondly, and in the light of the unique purpose that such an account would be required to fulfil, the standard features should relate to the benefits and functional limitations of the account.

Benefits embedded should include capital preservation and real growth prospects, conversion rights to an annuity on retirement, the ability to access the funds in a life crisis and the ability to make irregular, or small contributions. Appropriate restrictions in terms of access to funds, investment security of the funds and ease of the methods by which to make contributions to the funds would be necessary.

4. The standard features of a National Savings Fund

4.1 The features which would contribute towards the goals in annexure 2 are:

- A cost effective infrastructure utilizing economies of scale within the banking industry.
- Capital maintenance of amounts invested.
- Wide geographic reach through physical representation.
- Uniform terms and conditions which are readily understood for the operation of such accounts.
- Broad access to payment and transmission facilities.
- Existing risk management and governance processes and regulatory supervision.

4.2 Additional standard features would include:

- The introduction of rate structures that would reward preservation, but discourage premature withdrawal.
- The exclusion of dormancy so that accounts are not closed during periods of inactivity.
- The facility to convert accumulated savings to annuities at specified times.
- The restriction, however defined, of withdrawal facilities.

- The protection of balances from creditors or other claims against the account holder or dependents.
- The systemic production of income or balance certificates, where subsidies, rebates or linkages to other Old Age Pension benefits are contemplated.

4.3 National Savings Fund accounts could be ring-fenced in the accounts of the financial institutions, and separately reported to the required regulatory authority and subjected to desired investment requirements.

Furthermore, National Savings Fund accounts could be enhanced and reinforced with death or disability benefits to the holder.

4.4 As mentioned above, the South African Banking sector has recently introduced the Mzansi account which is designed to provide basic banking services to the under banked and unbanked. While this offering by banks is appropriate for basic banking services, and was structured as a price competitive offering, it was not designed as a retirement funding vehicle. There are some features embedded in the Mzansi account that may be beneficially transferred to a National Savings Fund product.

5. Economic Considerations of Interest Bearing Retirement Investments through National Savings Fund accounts.

5.1 The recognition of the need for a retirement funding vehicle, such as National Savings Fund accounts, to fill the gap between conventional pension and retirement funds and Old Age or State Pensions, carries a number of economic and taxation consequences.

These are elaborated upon below, but, in essence, it does appear that the weight of argument favours the introduction of interest bearing investments through National Savings Fund accounts. Furthermore, the banks' role as intermediators in the economy should result in stronger growth for the economy.

5.2 The taxation of interest income is, in itself problematical, as nominal interest is taxed without recognition being given to the inflation component of interest. The net result of calculating tax on the nominal interest earned is that inflation, and not the real income that is earned, is being taxed. In fact, the net interest income after tax is frequently less than the reduction in the real value of the investment attributable to inflation. This factor often makes interest-paying investments unattractive to investors.

The net effect of this is that the tax treatment has a direct impact on the investment decision, and results in serious arbitrage between the different classes of institution and the products they sell. Traditional pension fund portfolios are often unbalanced in favour of equity investments, and this is clearly undesirable if the reason for the imbalance is because of the tax provisions and not because of a fundamental difference in the underlying risk and return attributes of the product.

5.3 There are three main risks arising out of this situation.

5.3.1 The first is that the weight of institutional investments into equities can have the result that equity prices are pushed to levels well above the fundamental economic valuations of the equities.

5.3.2 The second is that the portfolio becomes vulnerable to market sentiment. These circumstances gave rise to a long period of growth in equity prices. This sustained growth rate was abruptly interrupted after the equity markets ran out of steam at the end of the 1990's. For many investors, falling equity prices, for almost three years, severely eroded retirement benefits.

5.3.3 The third is that a huge burden is being placed on the younger generation to look after the older one. This is a phenomenon which is not unique to South Africa. Many countries around the world are suffering from the same malaise.

5.4 We are certainly not suggesting that investment in interest-bearing investments should be preferred in some way. But we do suggest that the tax dispensation should not distort market behaviour. And that it does -

5.4.1 Firstly, by providing a significant incentive on saving for retirement through a particular class of institution, both because that investment is deductible and because an alternative investment in an interest-bearing security would result in taxable income, and

5.4.2 Secondly, by providing a heavy incentive to that institution investing in equities rather than interest bearing securities.

Moreover, because of the socio-economic stratification in South Africa, a significant proportion of its population falls outside the ambit of formal taxation, and consequently do not benefit at all from a dispensation which is structured around the benefit of tax deductibility of retirement contributions.

5.5 As stated in the report, the tax treatment of National Savings Fund accounts, while the subject of a separate study, would need to be harmonized with existing schemes. The difference in the target market of irregular or informal employment is that most of these people fall under the income tax threshold. In this respect innovative strategies in the form of tax credits that could be redeemed may be possible. This certainly bears consideration as part of the incentivisation to invest in National Savings Fund accounts, and that this fund should be deposit based and not equities based.

If it is accepted that informal and irregular savings can serve the dual purpose of capital preservation and long term retirement savings, then the same forms of income tax incentives available to pension funds should be available to other institutions where the rules for contributions and withdrawals are specified.

6. Issuers of Retirement Savings Fund accounts.

6.1 It is suggested that National Savings Fund accounts could be provided effectively and efficiently by institutions, other than conventional pension and provident funds.

Registered banks are required to comply with stringent prudential financial requirements. They have to meet solvency and liquidity requirements and are well placed to meet investment and other criteria to ensure the safety of depositors' funds. Furthermore, banks function as intermediaries between depositors and borrowers, thereby facilitating the mobilization of productive credit and working capital for the growth and development of commerce and industry. This mobilization has a more direct impact on economic activity than investment in existing shares of the JSE.

6.2 It is believed that the statutory requirements required for income tax allowances in respect of contributions, investments and withdrawals from pension funds and retirement funding vehicles should be reviewed so that other formally regulated institutions can participate and provide such services, on an equal footing, with the pension industry. Wealth accumulation for purposes of retirement funding can take different forms, but the setting of qualifying criteria for incentives and the reversal of tax credits where the investment, or realisation thereof, no longer serves the purpose of retirement funding, is an integral part of ensuring tax neutrality and freedom of choice for investors.

7. Conclusion

The Banking Council appreciates the opportunity to comment on the constructive work already undertaken in this field and hopes that this contribution will be of value in further deliberations.

We would be grateful for the opportunity to participate in any further workshops at which any clarification and/or other ideas can be discussed.

Banking Council South Africa.

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