Simeka Employee Benefits

Response by
Simeka Employee Benefits (Pty) Ltd
To
National Treasury
In respect of its
Retirement Fund Reform Discussion Paper

March 2005

Prepared by
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Managing Director

Simeka
- to plant a seed that will grow into a strong tree under which
the elders consult on matters of great import
[Tsonga]

Simeka Group

Simeka Employee Benefits is South Africa's leading black-owned consultancy business operating within the retirement funds industry. It is a sister company to Simeka Consulting, both falling under the ownership umbrella of Simeka Investment Holdings.

Simeka Investment Holdings has an established track record as a successful Black-owned and managed company. It is a recognized provider of strategic consulting services to Government and public corporations, and has an enviable track record of assignments which focused on providing advice and guidance to the public sector in managing change and transformation. Our success in this regard has been recognised by twice winning the Golden Arrow Award in the category of "Best Strategic Consultancy to Government", against formidable competition from all large established management consultancy companies, as well as being voted one of the top Empowerment Companies for 2002/2003.

As part of the Simeka Group, we benefit from the opportunities to add to our professional expertise, range of services and industry exposure through our association with our Group colleagues. In addition, the relationship fits in with our core belief and commitment to contributing to the economic advancement of South Africans to secure our business survival and growth.

Our Approach

We differentiate our approach from the traditional one in the following areas:

- Being an **independent, successful Black-owned and managed company** that is committed to the principles of true economic empowerment by sharing this with our clients and by practicing it within our own organization.
- **Moving beyond the broking paradigm** to providing our clients with strategic advice and ongoing partnering to ensure customized, cost-effective solutions to their individual employee benefit challenges.
- Better **applying the unique skills of our employee benefit professionals** to design creative solutions to complex financial and employee benefit problems.
- Seeing employee benefits **holistically** as all being part of the same "bio-system", and providing integrated solutions to the collective set of benefits.

About the Author

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David Gluckman completed his undergraduate degree at the University of Cape Town in 1987. He qualified as a Fellow of the Faculty of Actuaries (Scotland) in 1991. He has been working as an employee benefit actuary since 1992 specialising in the field of retirement fund consulting. He has co-authored a paper "Retirement Fund Conversions – Challenges and Risks", which was presented to the Actuarial Society of South Africa in 1997. David is currently a member of the Actuarial Society's Retirement Matters and Surplus Committees. David has been with the company since its establishment in 1998. He has also twice won the South African chess championship.

Introduction

Simeka fully endorses most of the principles and objectives as set out in National Treasury's discussion paper. In general we believe the paper represents a major step forward in the right directions. There is, however, clearly much work to be done as regards the detail, and we would welcome the opportunity to contribute within this process.

We are particularly supportive of the following key proposals:

- The establishment of a National Savings Fund aimed at people earning below the tax threshold and in informal employment.
- The elimination in the distinction as regards benefit structures and taxations between pension funds, provident funds and retirement annuity funds.
- The desirability of compelling purchase of a defined minimum inflation-proofed pension, with cash only being permitted in respect of any excess retirement payouts.
- The strong focus on improved fund governance.

Although we would welcome the opportunity to assist National Treasury all aspects covered in the discussion paper, we will at this stage confine our detailed comments to a few key areas of concern. This approach has been adopted deliberately in order to ensure that our key concerns are adequately highlighted rather than being lost within a much wider response.

Replacement Rate Targeting

Simeka supports the concept of targeting a specific post-retirement pension expressed as a percentage of pre-retirement income. Specifically we would support the proposal of a 75% replacement rate target for most people. There is, however, much work to be done to maximize the probability that any revised system will deliver the desired target replacement rates. The appropriate Social Old Age Pension dispensation and the associated means test, as well as the appropriate resultant tax dispensation, must be carefully designed to achieve the intended aims. There is a great danger that changes to the current system could result in unintended consequences. Simeka therefore believes there is an urgent need for a much greater level of modeling than the fairly rudimentary modeling undertaken in the discussion paper. National Treasury are no doubt aware of this need, and our main aim in raising the issue is simply to point out that the “devil is in the detail”, and that it is not possible to comment whether the proposals will work in practice without knowledge of the eventual tax regime, means test, etc.

Risk Costs

As is evidenced by the figures quoted on page 13 of the discussion paper, risk costs (e.g. death and disability insurance) clearly far outweigh other costs (e.g. administration fees, investment management fees, etc). The problem is expected to be exacerbated over the next decade or so as a consequence of the HIV/AIDS pandemic. In general we agree with the sentiment that such benefits meet a desirable social objective, and in general these benefits should be considered together with retirement savings needs for those in formal employment in order to ensure maximal economies of scale. We believe that one area that is not adequately addressed in the paper is the issue of cross subsidies in respect of such risk costs. In general, there are significant cross subsidies inherent in many occupational retirement funds where specifically higher income members subsidise the risk costs of lower income members. Simeka believes that the continuation of such cross subsidies represents a highly desirable social practice, and in fact we would support the extension of such cross-subsidies even beyond those that currently apply. We are therefore very concerned that some of the proposals in the discussion paper could easily result in the fragmentation of occupational retirement funds (e.g. if higher income earners could choose to opt out of occupational retirement funds in favour of individual retirement funds), and as such we are opposed to these proposals. The unintended consequence of allowing such fragmentation, if not very carefully controlled, could easily result in the "cherry-picking" of risks in a similar manner that has occurred in the medical schemes industry over the past 15 years with very unfortunate consequences for those members perceived as worse-than-average risks by the insurance industry. We therefore believe there is much further work and investigation required in this regard.

Form of Benefit Payment

Simeka strongly supports the proposal that retirement proceeds should be paid out in the form of a pension for life rather than a cash lump sum. We believe that such a requirement would meet a desirable social objective.

We would advocate that all retirement payouts must be used to secure a minimum pension for life including appropriate provision for inflationary increases and spouses' pensions upon the death of the retiree. If retirement capital were not sufficient to support such a minimum pension, than a lower pension would be paid to the retiree with no option for a cash payment.

We would support the concept of clearly defining the structure of such a minimum pension, which in our view should be much in excess of the monthly social old age pension (currently R780 per month).

One possible structure for such a minimum pension could be:

- Minimum guaranteed initial pension of 300% of the social old age pension.
- Including provision for targeted future pension increases of 100% of inflation depending upon affordability.
- Including a 50% spouse's pension payable after the death of the retiree.

Any retirement payouts in excess of the capital required to secure such a guaranteed pension could then be paid out in other forms (e.g. cash payment or transfer to a living annuity).

Such an approach would probably require the insurance industry to design appropriate and innovative pension products (e.g. combination of minimum legislated pension and living annuity).

We do, however, caution that the discussion paper does not adequately address reform in the annuity market. The paper instead appears to concentrate almost exclusively on the pre-retirement build-up phase. In Simeka's view such an approach is flawed because the problems of pre-retirement and post-retirement provision need to be considered holistically. Furthermore it is far from clear that footnote 35 is correct in stating that pension longevity risk is "best left to a well-capitalised and regulated insurance industry". There are many problems with the current annuity market that should be addressed in any holistic review of the industry (e.g. the well-publicised problems with living annuities and the with-profit annuity market where pension increases have in many cases significantly fallen well short of pensioner expectations).

Simeka agrees that there will be a need for transitional measures in respect of members of existing provident funds especially in respect of the portion of retirement proceeds generated from historically non tax-deductible member contributions (we are not overly concerned about the portion of retirement proceeds generated from historically tax deductible employer contributions). We do, however, believe that the socially desirable objective of a pension should possibly take precedence over such accrued expectations, and as such would advocate that such transitional measures by limited over a relatively short period (e.g. phasing-out period of perhaps 5 years).

Simeka supports the establishment of such a Fund to cater for people earning below the tax threshold and those in informal employment.

We do, however, caution that great care has to be taken to avoid unintended adverse consequences on occupational retirement funds if such a National Savings Fund had elements that cannot be replicated within the private sector. For example, if life crises access to savings were only permitted in the case of the National Savings Fund rather than in the case of occupational funds. Or alternatively if the tax dispensation were significantly more favourable within the National Savings Fund as opposed to occupational retirement funds. We repeat our concerns about risk costs, and in this case are concerned about the implications for risk coverage for those in formal employment who choose to exit occupational retirement funds in favour of the National Savings Fund. We believe much further work is required to avoid such unintended distortions.

We strongly advocate that the design of the National Savings Fund should be as simple as possible in order to achieve the required administration cost savings and economies of scale. We would therefore advocate a design along the following lines:

- No investment choice.
- Defined contribution arrangement.
- Most probably administered in a similar manner to Mzansi bank accounts with pricing subject to market competitive forces.
- No special bonus at retirement (a proposal which would appear to be contrary to the direction taken for occupational retirement funds).

We do believe, however, there is very significant opportunity for innovative thinking as regards the investment of these moneys and as regards the ultimate payouts at retirement.

For example, it is by no means clear that the defined contribution structure should be invested in a similar manner to occupational retirement funds. There could be scope to consider the National Savings Fund as one element of the Government’s borrowing requirements – e.g. Government could guarantee an annual bonus on an inflation-linked basis in which case any contributions to the National Savings Fund could be treated in a similar manner to Government borrowings in respect of bonds. From the members’ perspective such an approach could be attractive in that Government guarantees would establish a certain level of trust which will be vital to the success of such a National Savings Fund (it will be essential for such a Fund to attract sufficient numbers to ensure the required economies of scale). In other words the National Savings Fund need not be fully funded in the conventional sense, although careful modeling will be required by National Treasury to ensure the affordability of any such structure.

There could also be scope for significant innovative thinking as regards the eventual payouts from such a National Savings Fund. For example, one way to achieve desired cost savings would be to offer a facility to convert capital at retirement to a monthly pension secured from the Government which could be paid together with the social old age pension.

Commissions

Simeka are supportive of National Treasury's express wish to eliminate unnecessary costs within the retirement fund industry.

It is, however, not clear what is meant by paragraph 4.2.8 of the discussion paper which states "not pay commission or service fees to an intermediary for inducing a member to join a fund".

If this only refers to the current practice of paying significant up front commissions for retirement annuities for a pure sales function, we are not necessarily opposed to the proposal - particularly for those people who have the more suitable alternative of an occupational retirement fund.

But we do believe an appropriate "as and when" payment is desirable in the case of intermediaries providing advice or servicing. Else such vital functions will either not be performed, or performed inadequately, or alternatively will be provided by the service providers and costed for within their administration charges (with no net saving for the member).

The problem would be lessened for those in formal employment were the current compulsory occupational retirement fund system to be maintained. Simeka would, in fact, favour this approach which would meet the desired social objective of minimising costs, and would also prevent the fragmentation of occupational funds (with dangers highlighted elsewhere in this report).

If members of occupational retirement funds were permitted to augment their savings by way of additional voluntary contributions to these funds (perhaps by way of salary sacrifice on a tax-deductible basis), then that would represent the cost optimal solution for those in formal employment. Such additional savings could be channeled on a nil, or at least extremely low, cost basis which would go a long way to addressing the valid concerns of National Treasury as regards intermediary commissions.

There would, however, remain a gap in respect of those people not in formal employment, but for whom the National Savings Fund is not necessarily attractive (e.g. workers in the informal sector earnings above the tax threshold). The current system whereby an intermediary can earn up front commission does at least mean that retirement annuities are marketed to such people. There is a danger that eliminating such commissions would have the unintended consequence of this segment of the population further reducing already low levels of savings. One possible solution would be to make the National Savings Fund attractive to this segment of the population as well. We believe that much further consideration is required as regards this matter.

We believe that the promotion of such funds is essential for small to medium size employers in order to achieve the desired economies of scale. Whilst we appreciate that the Registrar has certain governance concerns as regards these vehicles, it is in our view absolutely essential that the country develops a well-regulated and extensive umbrella fund industry for cost savings reasons.

Simeka would favour a consolidation of the existing multitude of small funds into well-regulated umbrella funds. Statistics from the FSB show that there are thousands of such small funds, and we believe that significant cost savings could be achieved by the mandatory consolidation of such standalone funds into umbrella funds.

We should point out that the governance of many of these smaller fund is, in our experience, in an even worse state than the much larger umbrella funds.

Simeka would therefore support a legislated minimum number of members for standalone funds (e.g. 200 members), below which consolidation into an umbrella fund would be mandatory. Such a step would reduce the number of funds in the country by a factor of thousands, and would result in significant cost savings within the industry as a whole.

That said, we do absolutely agree that urgent steps are required to address governance concerns within umbrella funds. South Africa urgently needs a well-regulated umbrella fund industry with appropriate protection of member rights, and also acknowledgement and due recognition of the pivotal role of the promoters of such funds.

Simeka are well placed to assist National Treasury with the required reform of the umbrella fund industry.

Simeka's view is that such proposals are unlikely to work unless these are precisely defined and with minimum investment percentages being prescribed.

That said there are very valid concerns about the quantum of appropriate SRIs as well as the liquidity and valuation of such investments.

As a start work needs to be done to quantify the pool of investments that would meet the defined SRI criteria. Minimum percentages could be set taking such numbers into account.

Because of the dangers of unintended consequences, we would advocate a careful and measured approach to this issue. Possibly a very low percentage should be prescribed up front (perhaps 1% of Fund assets) with this percentage to be gradually increased depending upon successes achieved. A very low legislated percentage investment would at least compel trustees to consider the issue in a careful manner as part of the development of their investment strategies.

We are, however, concerned about the costs and abuses that could result from thousands of funds making SRI decisions in a fragmented manner. A possible solution would be for Government to issue SRI Bonds to retirement funds with the proceeds allocated centrally (perhaps by the PIC) to deserving projects. If an adequate market were developed for such bonds that could go a long way to addressing our concerns about costs, valuation and abuses that could easily result from such legislation not being carefully thought through.

Conclusion

We have attempted to highlight the key concerns of Simeka arising from the National Treasury discussion paper.

Whilst we do have concerns, we would like to reiterate that in general we believe the National Treasury paper is well thought out, and is a bold and refreshing step forward in the right direction.

Simeka can make a significant contribution as regards the development and finalisation of many of the National Treasury proposals, and we would welcome the opportunity to assist National Treasury in their deliberations.

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