

SOCIAL DEVELOPMENT

Reform of Retirement Provisions

DISCUSSION DOCUMENT



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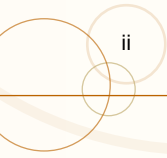
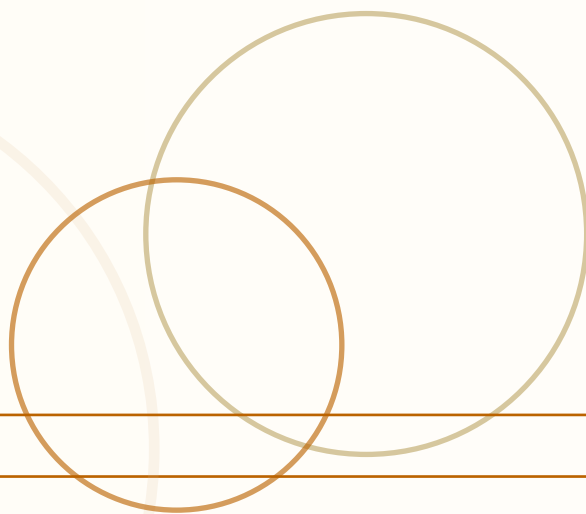


social development

Department:
Social Development
REPUBLIC OF SOUTH AFRICA



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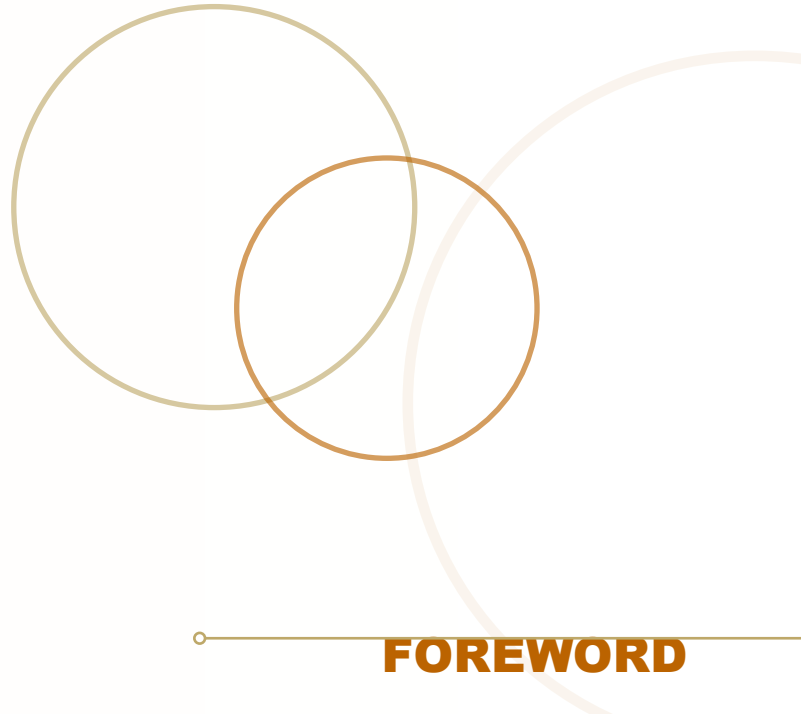
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FOREWORD



FOREWORD BY THE MINISTER

Our democratic state inherited a fragmented and uncoordinated social security system that was geared towards servicing the needs of a few.


That system continues to engender limited access to appropriate forms of social security. Since the advent of democracy in our country, our ongoing desire has been our quest to ensure the provision of a comprehensive social security system that is based on the needs of our people, a system

that is fair, just and affordable as we articulate in various documents, including but not limited to the Reconstruction and Development Programme, the White Paper on Social Welfare and the Constitution of our country.

As part of our social transformation journey, we have, over the last twelve years, removed the vestiges of racial discrimination in respect of access to social assistance.

“I therefore call on all who have an interest in the deepening of our democracy and service delivery...”





As a result, more than 11 million South Africans now access social grants. These beneficiaries would otherwise have little or no income support for either themselves or their dependents. The establishment of the South African Social Security Agency was our latest effort to advance our responsibility to improve the efficiency and effectiveness of the management and administration of social assistance and ensure equitable access by all eligible South Africans across the country, irrespective of the province in which they reside. Our efforts are contributing positively towards the social inclusion of the historically marginalised persons and the sustainability of their livelihoods.

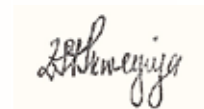
Over the next few years we will continue to advance our agenda to establish a comprehensive social security system for South Africa. Therefore we are now focusing on the reform of contributory schemes. Already the Department of Labour has expanded the provision of unemployment insurance to low income earners, the Department of Health has started the dialogue to increase participation in medical scheme coverage and the Department of Transport will soon initiate the process of public involvement in the reform the Road Accident Fund.

Our honest and frank reflection of South Africa's retirement provisions is that the system is in dire need of reform. Retirement provisions, if properly designed and regulated, should help retain the dignity of contributors upon retirement, by guaranteeing them adequate income to sustain their livelihoods, and those of their dependents.

By means of this document, the Department of Social Development is launching a public consultation

process on retirement reform. Retirement provisions do not only provide income smoothing, in the life of an individual, from employable age to old age. Properly designed, these provisions should also provide insurance covering contingencies such as death, survivor's benefits and post-retirement medical provisions. Instead of becoming candidates for state-provided welfare only, participation in retirement schemes enables contributors to benefit from the principles of solidarity on which the system should be based. Failure to provide adequately for retirement results in persons living in poverty during the twilight years of their lives. Invariably, society is left with the responsibility to provide for them or their dependents with the basic income support for survival.

This consultation we are embarking upon confirms government's view that a matter as important as reform of retirement provisions cannot be the exclusive preserve of government or the retirement sector. All South Africans from all walks of life should participate in this historic process charting a future retirement system for the country. I therefore call on all who have an interest in deepening our democracy and service delivery to engage the retirement reform proposals being advanced with a view to building on the hope and ingenuity of our people in this the Age of Hope.



Dr. ZST Skweyiya

Minister for Social Development

FOREWORD BY THE DIRECTOR GENERAL

This discussion document is designed to launch a national public discourse on a subject matter that carries with it profound, social, economic, political and personal implications: the reform of South Africa's retirement provisions.

Chapters 1 and 2 are dedicated to giving an exposition of the international developments and best practices in retirement reform, and an analysis and assessment of the adequacy or otherwise of South Africa's retirement provisions, respectively. Chapter 3 specifically advances reform proposals aimed at guaranteeing, to all South Africans, adequate income support upon their retirement, income security in the event of their disability, and provision for their surviving dependents in the event of death.

In our overview of the global situation on this subject matter, we noted with appreciation that our effort at reforming the South African retirement provisions is not an isolated development. Interestingly, regular reviews and reforms have become ongoing features of retirement systems in most leading countries of both the developing and the developed world. We have extracted an overwhelming global impression on retirement reform, gleaned from a detailed literature review of some leading countries in Latin America, the United Kingdom, Europe and Scandinavia, complemented by direct interactions with their resident experts and seasoned with contemporary ideas from eminent social security experts and erudite researchers from regional and international social security formations.

“I invite you to contribute to the debate...”



Invariably, the primary object of the reviews of retirement provisions in these countries is to examine the adequacies of their retirement systems and, where necessary, initiate reforms with a view to improving the benefits structure, extending the system coverage to the historically marginalised and vulnerable persons, ensuring the sustainability of the system and enhancing governance arrangements. In this regard, I am delighted to say, their destiny and ours is one.

A closer look at the South African retirement system reveals that although we spend significant resources towards retirement, this system is frightfully inadequate and completely out of sync with progressive international trends. Crisply put, the South African system of retirement provision is defunct, as evidenced by its strategic design weaknesses, corroborated by its limited coverage of the poor, insufficiency of replacement rates, exorbitant costs for benefits administration, archaic incentive structures, shockingly deficient regulatory dispensation, etc.

The inspiration drawn from contemporary thinking on retirement reform and the accepted best practices behind the current global trends has impelled us to resist the temptation to simply tinker with the margins of our defunct system and consider, as we have, the desirability of fundamental reform of retirement provisions in South Africa. Accordingly, it is my considered view that the reform proposals being advanced in this document attempt to respond to the need for fundamental reform for the benefit of all and lay a basis for a design that sets us on a path towards the evolution of a quintessentially South African solution, in sync with the world. This, I most sincerely believe, is an important link in the chain of initiatives that contribute towards the modelling of South Africa as a developmental state.

As will be seen, even from a cursory reading of this document, the normative approach adopted in the formulation of these proposals is predicated on government's commitment to develop a comprehensive social security system for South Africa, anchored around three pillars, being, first, a non-contributory system of social assistance providing a safety net for the most vulnerable, second, a mandatory contributory system of social insurance covering all income earners and, third, a voluntary scheme in terms of which all are free to purchase additional cover.

As more fully appears from the substantive nature of the work covered in this document, the team worked tirelessly and selflessly. In acknowledgment of this great effort, my thanks go to the FOSAD Social Sector Cluster Task Team under the leadership of Mr Selwyn Jehoma (Deputy Director General: Social Security, supported by Mr. Alex van den Heever (Lead Researcher) and Ms Dimakatso Moutloatse (Acting Chief Director: Social Security Policy and Planning).

It now remains for me to, as I hereby do, invite all South Africans, in the most animated language, to join in and contribute to this healthy national discourse that has as its strategic objective the ushering in of an epochal change in the country's retirement dispensation.

Asikhulume!!! (Lets us talk)

Need Signature

Vusi Madonsela
Director General

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EXECUTIVE SUMMARY



BACKGROUND

During January 2002, government adopted the concept of a three-pillar framework for a Comprehensive Social Security system. Government acknowledges that significant progress was made in respect of pillar one, the non-contributory system, through the rapid expansion of the social safety net in the form of social grants and the provision of the social wage or basic services to millions of South Africans.

Government emphasised the need to now focus on and reform the second pillar of social security dealing with retirement provision, social health insurance, road accident insurance, occupational diseases and injuries and unemployment insurance. While measurable progress was made in the expansion and solvency of the Unemployment Insurance Fund, work is ongoing in developing policy options for social health insurance and proposals have been presented for the reform of the Road Accident Fund. The Social Cluster Task Team has now completed a review of retirement provisions and presents several recommendations.

The research team looked at retirement systems internationally, evaluated the current situation in South Africa, and analysed previous and ongoing proposals in ongoing discourse, noting views expressed by business and interested members of the public. Representatives from the Social Cluster visited Brazil, Mexico, Spain and the United Kingdom with a view to gain from the retirement designs in these countries. In addition, the benefits of views of experts from the Netherlands, Sweden and several members of the International Social Security Association (ISSA), (of which the Director General of Social Development is a member of its highest decision making body, the Bureau of ISSA), are being canvassed.

The Social Cluster's review and proposals aim to address the lack of a mandatory government retirement system that is in line with the principles of social security.

PROBLEM STATEMENT

South Africa's first pillar of basic social assistance to older persons has been successful in providing income support to more than 66% of people and research confirms that old age pensions significantly alleviate poverty amongst the elderly and many of their dependants.

Notwithstanding the successes of the old age pension programme, South Africa's system of retirement protection is fragmented and not financed in accordance with social security principles. Despite deceptively high levels of contributions to retirement schemes, the gap between those employed and the non-contributors towards retirement savings is high. While very substantial contributions are made towards employment-based contributory schemes in South Africa, the quality of these benefits, including survivor benefits, is questionable.

Income earners in pension schemes retire with insufficient income relative to what they earned during employment, despite the fact that government subsidises these savings. The review reveals that administration costs of retirement products are excessive by any standards and that these impact on the quality of benefits. Government subsidises contributors at a cost of around R28 billion provided to old age pensioners. These subsidies benefit only the middle and high-income earners.

The consequences of governance failure and fraud in the private retirement system fall to an excessive degree on individual families.

EXECUTIVE SUMMARY

THE SOUTH AFRICAN SYSTEM OF RETIREMENT

The system of retirement provision in South Africa can simply be characterised as a fragmented three-pillar system, with no universal minimum level of protection, and a second pillar that operates according to the rules of a third pillar. The section below outlines the gaps, challenges and weaknesses.

Historical context

The South African system of retirement has followed a fairly unique path compared to many countries. The system has evolved from a fully privatised arrangement based on occupational and individual forms of cover. This has been supplemented by a safety-net; the means tested old age pension.

The absence of a mandatory tier in the South African contributory system therefore makes it unique from an international perspective. Furthermore, the absence of any form of state provision (or delivery) of an earnings-related retirement system is unusual.

Assessment of retirement coverage

According to the Financial Services Board's Annual Report of 2004, South Africa has close on 14 000 retirement funds with a total membership of 9.9 million, of which 8.7 million were active members and 1.13 million were beneficiaries of the pension funds. The figures include participation in more than one fund (a double count of 1.3 -1.4 for every contributor is estimated) and are therefore an inaccurate reflection of total participation.

Effective coverage cannot be gauged by comparing the 8.7 million active members in pension funds with the 7 million people in formal employment (Stats SA, June 2005). An indication of the

scale of the gap in coverage can be shown when reference is made to the total employed population (rather than employees in the formal sector), which stands at 11.3 million (Stats SA, 2005) that is significantly higher than the number of existing contributors.

The total number of contributors to retirement funds is 5.9 million based on an assumed double-count of 1.4 million. Since the total potential contributors are 11.3 million (excluding agricultural and unspecified workers in the Life Force Survey), the total number of employed non-contributors could be as high as 5.4 million. The majority of these South Africans become dependent on social assistance. Roughly 5.4 million people could make a contribution toward their retirement.

The quality of coverage

Coverage is only one indicator of the adequacy of the current retirement system. A more important issue is the quality of the coverage. There are many factors that could contribute to a reduction in the value of benefits, such as early withdrawals; switching into expensive private annuity products; high administration costs; lumpiness of investment performance; fund failures; and gaps in lifetime contributions.

Almost all South Africa's pension fund types vary significantly from the "normal" pensioner ratio due to significant distortions that exist in fund participation and employment practices. The Team's findings indicate that the excessively high pensioner ratios could in part be explained by low retirement ages, declines through the practice of permitting unnecessary early retirement or a reduction in the size of the labour force through a policy of staff reductions or through the sale and/or transfer of subsidiary entities, while retaining the pension liability in the original fund.

Retirement funds for the public and semi-public sector do not reflect poor quality of coverage, which is in all likelihood due to its mandatory nature.

Replacement rates

Replacement rates refer to the income received or “replaced” by retirement income from a pension fund. It has proved difficult to accurately uncover the replacement rates or returns realised by pension fund members. However, a simple assessment was undertaken to provide some idea of the effectiveness of retirement provision for those participating in retirement funds.

The results from the Team’s assessment suggest that in private retirement provision there is a distinct, detectable drop in incomes as people go into retirement, roughly of the order of 50% or more. The income declines of the lowest income groups appear less severe because of the impact of the state old age pension. Another alternative methodology was used and the results expose the fact that replacement rates from some parts of the industry could be as low as 23.9% with high administration costs.

Administration charges or charge ratios

Administration costs incurred by retirement funds impact significantly on the final value of any retirement payout. Rusconi’s recent appraisal (2004) of retirement fund administration costs of the private industry in South Africa revealed very high charges. The review exposed the fact that charge ratios for “most policies” range between 26.7% and 43.2%.

Disturbing findings from the analysis show that amongst self-administered funds, the most important private retirement arrangement, charge ratios range from 17.0% to 27.1% in the “core range” and from 13.4% to 38.7% in the “outside range”.

These findings of administration costs however look “good” compared to individual products that show charge ratios ranging from 26.7% to 43.2%. The problematic nature of these expenses is not publicised in the reported statistics of the Registrar of Pension Funds, which purported that administration costs were around 13.1% in 2002 and 11.5% in 2003.

Poor transparency and a resulting lack of price competition are amongst the key reasons for these high administration costs. The evidence suggests that in South Africa virtually all pension fund members pay charges way in excess of international norms. Costs are systematically higher for smaller funds. A pre-condition for a properly functioning market of any form is that the price is transparent, thereby providing a basis for the choice of alternative service providers.

Subsidy Framework

Government subsidises retirement provisions through two mechanisms: the first involves the “on-balance-sheet” allocations from general tax revenue to fund the means tested old age pension; and the second takes the form of an “off-balance-sheet” system of Tax Expenditure Subsidies (TESs) for individuals contributing to private retirement arrangements. The latter subsidy is heavily biased in favour of higher-income individuals and raises significant equity and efficiency questions.

The South African tax regime anachronistically is the only mechanism for providing subsidies to the contributory retirement provision. The tax subsidy allows individuals to deviate from the progressive personal income tax regime on the basis of their contributions to a retirement fund arrangement.

The effective total contribution subsidy for retirement provided was estimated at R17.8 billion (net of deferred taxation) in 2005. Combining both the

EXECUTIVE SUMMARY

contribution subsidy and the subsidy on retirement investment earnings gives a figure of R28.5 billion or 1.9% of GDP. Were the old age pension to be universalised, i.e. the means test removed, the additional cost to government would amount to R8 billion in 2005 prices. If the subsidy to private retirement were removed entirely and replaced by this allocation, coupled with a mandate (rather than an incentive) to join a retirement fund, Government would save R20.3 billion annually and potentially improve on existing levels of private participation.

The key conclusions of international World Bank economists are that no basis exists for using the tax system to encourage private savings. *“Even with the incentive, people may not save enough. It is hard to define what is a ‘sufficient’ retirement income, beyond a reasonable minimum. The best way of being paternalist is mandating minimum retirement savings, either through state provision (the ‘first pillar’) or compulsory contributions to private funds (the ‘second pillar’).”* (Whitehouse, 2001, pp.3-4).

Post-retirement Medical Scheme Cover/Contribution Protection

Many people face a significant decline in income going into retirement and many who rely on their retirement savings to participate in a medical scheme end up being disappointed. This period in their lives also coincides with an increase in healthcare need, particularly in relation to chronic conditions. In the past many employers supported their post-retirement group. More recently however many have begun to remove this support. In some cases this has involved reneging on past promises. In the bulk of cases it merely involves the removal of this benefit in respect of current employees.

The rapid retrenchment of these benefits by employers over a relatively short period reflects the

need for more robust social security measures instead of relying exclusively on the goodwill of employers.

The arrangements used by employers to pre-fund post-retirement medical scheme obligation are fragmented, lack transparency, and are generally not transferred when employees change employment. If a more effective arrangement is not made, the existing declining trends in protection will persist.

The central social security issue is therefore to protect the continuity of medical scheme contributions into the post-retirement period. There is also a need to protect the contributions of dependants in the case of the death and disability of the employee.

Regulatory framework

The private retirement industry in South Africa had R1 trillion under management in the almost 14,000 funds in 2004. The existing regulatory authority cannot reasonably be assumed to be providing adequate oversight.

Many recently identified regulatory problems in the market can potentially be traced back to the following issues:

- Poor governance arrangements;
- Conflicts of interest amongst financial advisors, employers and trustees;
- Weak regulatory oversight.

The existing regulatory framework materially affects the value of retirement arrangements in South Africa. Whereas regulatory action may currently focus on the easy cases e.g. massive fraud; fund collapses; etc, the less visible but potentially far more devastating losses are not addressed. The following are recently confirmed as occurring:

- The removal of surplus funds under questionable circumstances. Conflicts of interest between actuarial advisors, brokers and employers all make this possible.
- Non-payment of benefits, incomplete payment of benefits, and late payment of benefits; many retirement funds have little incentive to pro-actively ensure that members receive the benefits to which they are entitled.
- Administration companies and brokers are often in a position to distort the value of the fees to which they are entitled.

POLICY PROPOSALS FOR REFORM

The old age grant should be reconstituted from a means-tested social assistance programme to a universal non-contributory benefit available to all citizens and qualifying residents. The additional cost to Government of removing the means test is estimated at R9 billion and can easily be funded.

The existing TES to higher income groups for retirement lacks any defensible rationale and should be significantly revised. This will free up close to R28 billion.

In order to ensure adequate minimum levels of contributory, retirement provision, a mandatory contributory system should be introduced. Contributions to this system should potentially be mandated from the age of 25 for all income earners. Contributions should at least be set at 15% of pre-tax income to achieve target replacement rates of 40% for lower income earners, inclusive of the old age pension benefit. Contributors should include all persons above the tax threshold.

Two tiers of mandatory contribution should be considered. The first tier, reflecting 50% of the contribution, should potentially go to a pay-as-you-go (PAYG) defined benefit. No opt-out should be permitted for employers or individuals in respect of the PAYG portion. This is to prevent the ratio of current members to pensioners from deviating from that for all taxpayers. The PAYG tier should be formula-based, with automatic adjustments in benefits through time if the ratio of contributors to beneficiaries changes.

Over-and-above the PAYG mandatory contribution, a fully funded defined contribution benefit should be offered.

To further support the mandatory system a Government Sponsored Retirement Fund (GSRF) should be introduced. This should be made the default retirement provider unless an employer opts out. An employer should potentially be permitted to opt out if they participate in an accredited retirement fund for the defined contribution portion of the mandatory system

To obtain accreditation for any opt out environment retirement funds should be required to meet governance, transparency and cost standards. For instance, accredited funds should be required to achieve charge ratios below 15%. As in many countries, private funds serving the mandatory tier should be made up of large funds with sufficient economies of scale and appropriate governance standards to comply with such requirements.

The mandatory retirement arrangement should incorporate provisions for post-retirement medical scheme contributions as well as death and disability cover.

EXECUTIVE SUMMARY

MOTIVATION FOR REFORMING RETIREMENT PROVISIONS

Building the Second Pillar for Retirement

The democratic government has over the last 12 years focused on integrating social security and economic growth in a wider development strategy. Through this development strategy South Africa has seen both the successes of rapidly expanding social security measures such as the various social assistance grants, while securing measurable and sustainable economic growth.

In line with the comprehensive social security framework adopted by government during 2002, and the consolidation of the social assistance programme, government has prioritised addressing the defects in the second pillar or contributory system.

The South African system of retirement provisions, has evolved exclusively from a privatised system with no explicit policy framework. Although the retirement system has by world standards shown significant commercial success, it has failed to provide adequate and quality coverage to a significant portion of the population. It is also not

clear that those presently covered receive value for money. The result has been that many people face significantly reduced standards of living going into retirement.

The indicated poor value of replacement rates is apparently exacerbated by high administration costs; early withdrawals; and limited prospective protection from sharp commercial practices. There is furthermore a strong argument to make that value for money in existing retirement arrangements is affected by poor transparency with the result that the public are incapable of making informed decisions about products and arrangements.

CONCLUSION

The event of retirement has profound personal, social and economic consequences. There is a need for all South Africans to begin a debate of the road forward. South Africans must engage in reform to ensure that we build a more optimal income-smoothing regime. This document is not only aimed at contributing to the ongoing debate, but also serves to give it impetus and it is trusted that it will be a catalyst in our way forward.

Building a Caring Society. Together.



CHAPTER ONE - LITERATURE REVIEW



1.1. INTRODUCTION

This report forms part of a series of four reports on Retirement Reform in South Africa provided to the Social Cluster Task Group on Comprehensive Social Security. It provides a general literature review of issues relevant to retirement reform in South Africa; the purpose of which is to contextualise the domestic discussion within emerging international debates.

International debate concerning retirement reform over the past twenty years has been triggered by significant demographic changes in countries that offered a high degree of social security protection to its citizens, mainly the industrialised countries with mature economies.

A marked distinction exists, however, between the starting positions of most countries engaged in this debate and that of South Africa. Whereas most developed and developing countries want to shift from single- to multi-pillar retirement systems, South Africa sits at the opposite extreme with almost no social security elements apart from social assistance.

Consequently, many of the technical discussions around transitional shifts from single- to multi-tier systems are irrelevant to South Africa. What is relevant, however, is the need to explicitly outline those missing elements of a social security system that are important to the future of South Africa. This report does not identify the gaps in the South African system, but it does identify what the potential best-practices should be.

1.2. MAJOR EMERGING THEMES

Latin American and, to a limited extent, Eastern European countries are busy reforming their pension

systems. Much of this resulted from realisations that came from World Bank studies, warning of coming crises in state-run pay-as-you-go (PAYG) pension systems.

The main threat to traditional PAYG systems centred on aging, which caused the retired population to become more dependent on the working population. However, while the problem of aging is quite serious in industrialised countries, particularly with the post-war baby boomers, developing countries have relatively young populations.

Trying to address the demographic risks, the World Bank prescribed major private sector involvement in retirement provision, an option not specifically necessary to address demographic risk. The World Bank backed up these policy prescriptions by providing loans and technical assistance where countries were implementing reform; these involved 204 loans to 68 countries by 2001. (World Bank, 2001, p.8).

Reform approaches can be distinguished according to whether they are non-structural (parametric) or structural (non-parametric). Parametric reforms of the former type tend to focus on changes to methods of calculating PAYG pension contributions and benefits, while non-parametric reforms involve a replacement of a portion of the public retirement system by a private system. Structural reforms involve radical changes to the retirement system. (Mesa-Lago, 2002, .2).

Three general models of structural pension reform focused on in Latin America are broadly defined as (based on Mesa-Lago, 2002, p.3):

- **Substitutive:** “This model involves the full replacement of the public by a private system. The historical public system is closed to new applicants and phased out over time. All new applicants are diverted to private funds.”

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- **Parallel:** “The public sector system is not closed down, but reformed, with the private sector introduced as competition.”
- **Mixed:** “The public system is not closed down; continues to offer a basic pension along with a private system offering a supplementary pension.”

Aside from the eleven Latin American countries listed in **table 1**, Central and Eastern European countries (including Hungary, Poland, Croatia, Latvia, and Kazakhstan) have implemented structural reforms. Hungary was the first to develop and implement a shift to a multi-pillar system beginning in 1997 due to notable imbalances in the PAYG system resulting from circumstances specific to that country. Thus, general aging of the population was not the central concern. (Rocha et al, March 2000).

“The Hungarian public PAYG scheme arrived in the 1990s with difficulties to balance expenditures and revenues, despite charging one of the highest

contribution rates in the world During the 1990s the PAYG system was subject to further strong pressures, caused by a significant loss of revenues and a steep increase in the system dependency ratio. ... The erosion in the base is clear from the decline in the ratio of the covered wage bill to the wage bill and in the ratio of the wage bill to labor income. Such base erosion was due not only to problems of ceilings and exemptions, but also to increasing efforts to evade the heavy payroll tax. A reduction in the overall labor share due to a period of wage compression also contributed to the decline in the base and revenues relative to GDP.” (Rocha et al, March 2000, p.3).

“The fast increase in the system dependency ratio during the 1990s was not due to adverse demographics, but primarily to a fast increase in the number of pensioners during the early stages of the transition, due to lax early retirement and disability rules.” (Rocha et al, March 2000, p.3).

Table 1: General Models and Features of the Eleven Pension Reforms in Latin America, 2002

| Model | Country and date of implementation | System | Contributions | Benefits | Financial Regime | Administration |
|--------------|------------------------------------|------------|---------------|-------------|-------------------|----------------------|
| Substitutive | Chile: May 1981 | Private | Defined | Non-defined | FFI | Private ^b |
| | Bolivia: May 1997 | | | | | |
| | Mexico: Sept. 1997 | | | | | |
| | El Salvador: May 1998 | | | | | |
| | Nicaragua: 2002 | | | | | |
| | Dominican Rep 2003-5 | | | | | |
| Parallel | Peru: June 1993 | Public or | Non-defined | Defined | PAYG ^a | Public |
| | Columbia: April 1994 | Private | Defined | Non-Defined | FFI | Private ^b |
| Mixed | Argentina: July 1994 | Public and | Non-defined | Defined | PAYG ^a | Public |
| | Uruguay: April 1996 | Private | Defined | Non-defined | FFI | Multiple |
| | Costa Rica: May 2001 | | | | | |

a In Peru, Argentina and Uruguay, but PCF in Columbia and Costa Rica.

b Multiple in Mexico, Dominican Republic and Columbia.

Source: Legislation of eleven countries

Source: Mesa-Largo, 2002, p.2 (table 2).

Abbreviations in table 1:

PAYG: Pay-as-you-go; FFI: Fully-funded, individual; PCF: Partial collective funding

The World Bank framework is more than a recommendation to privatise public pension systems. Instead a conceptual framework, which segments the retirement system into three pillars, is proposed: a first pillar which addresses poverty and minimum benefit requirements; a second pillar which offers minimum income-related protection; and a third pillar which offers voluntary income-related benefits. These pillars match basic themes in social security. The design of each pillar will need to consider a range of options, depending on the local issues and policy priorities of individual nations.

“What emerges from ... interactions with policy-makers, pension experts, and representatives from civil society in client and donor countries is the continued relevance of the main objectives of pension systems – poverty alleviation and consumption smoothing – and of the broader goal of social protection. The Bank continues to perceive advantages in multipillar designs that contain some funded element when conditions are appropriate but increasingly recognizes that a range of choices can help policymakers to achieve effective old age protection in a fiscally responsible manner.” World Bank, 2001, p.1).

“The suggested multipillar pension system is composed of some combination of five basic elements: (a) a non-contributory or “zero pillar” (in the form of a demogrant or social pension) that provides a minimal level of protection; (b) a “first-pillar” contributory system that is linked to varying degrees of earnings and seeks to replace some portion of income; (c) a mandatory “second pillar” that is essentially an individual savings account but can be constructed in a variety of ways; (d) voluntary “third-pillar” arrangements can take many forms (individual, employer sponsored, defined benefit, defined contribution) but are essentially flexible and discretionary in nature; and (e) informal

intrafamily or intergenerational sources of both financial and non-financial support to the elderly, including access to health care and housing. For a variety of reasons, a system that incorporates as many of these elements as possible, depending on the preferences of individual countries as well as the level and incidence of transaction costs, can, through diversification, deliver retirement income more effectively and efficiently.” World Bank, 2001, pp.1-2).

The abovementioned is an update of the original World Bank framework which only identified three pillars. The “zero pillar” and the “fifth pillar” (described under (e) in the above quotation) have been added.

The World Bank goals for a pension system include both primary (first order) and secondary (second order) requirements. The former include the provision of an “adequate, affordable, sustainable, and robust retirement income, while seeking to implement welfare-improving schemes in a manner appropriate to the individual country ...” (World Bank, 2001, pp.6).

The second order goals, according to the World Bank, “seek to create positive developmental outcomes by minimizing the potential negative impacts that pension systems may have on labor markets and macroeconomic stability while leveraging positive impacts through increased national saving and financial market development.” (World Bank, 2001, pp. 6).

The International Labour Organisation (ILO), however, tends to focus on the primary objectives of a pension system with the following objectives (Gillion, 2000):

- “The extension of coverage to all members of the population”;

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- *“Protection against poverty in old age, during disability, or on death of the wage earner for all members of the population”;*
- *“Provision of an income, in replacement for earnings lost as a result of voluntary or involuntary retirement, for all those who have contributed”;*
- *“Adjustment of this income to take account of inflation and, at least to some extent, of the general rise in living standards”;*
- *“Creation of an environment for the development of additional voluntary provisions for retirement income”.*

“Most of these principles are contained in the various International Labour Standards established by the ILO, which also set out the minimum level of benefits: broadly speaking, these amount to a replacement rate of 40 percent of previous earnings after 30 years of contributions, with safeguards and minima for those whose lifetime earnings were low, or who experienced significant periods of non-contribution.” (Gillion, 2000).

The difference between the World Bank and ILO approaches seem to be far more in the importance of second-order implications to pension system design. While the ILO prefers to focus on optimising the primary goals, the World Bank feels that a system satisfying the first-order objectives may not satisfy the second-order objectives.

This difference may prove to be less important when practical options are considered. Those who disagree with the World Bank position are concerned that the second-order objectives are given higher priority to favour policy options involving the full funding of retirement obligations. Such strategies are seen to promote standard and questionable supply-side macroeconomic policies rather than develop stable social security systems.

How important a country rates the second-order goals when considering pension system reform, will influence whether a structural or non-structural reform is followed. The former corrects imbalances in any PAYG system, leaving the structure unaffected. The latter involves structural changes which divide Government intervention into unfunded and funded parts.

However, public and private systems of retirement provision are not complete substitutes, and the optimal the system design will have each do what they do best. Even so, certain of the claims made in respect of private arrangements are questioned, including those regarding second-order matters. (Barr, 2004, pp.192-198; Mesa-Lago, 2004; Orzag et al, 2001).

The central features of a *public system* are (from Mesa-Lago, 2004, pp.1-2):

- *“non-defined contributions (tending to increase in the long term)”;*
- *“defined benefits (the law determines the formula to calculate the pension, often with a minimum and a maximum, but financial and demographic conditions could make those benefits unfeasible in the long run)”;*
- *“financial regime based on pay-as-you-go (PAYG) or partial collective funding (PCF)”;* and
- *“public administration”.*

The central features of a *private system* are (from Mesa-Lago, 2004, p.2):

- *“defined contributions (set at a fixed level over the long term)”;*
- *“non-defined benefits (uncertain, based on what is accumulated in the individual account of the insured, which will depend on his/her salary level, amount and density of contributions, and the investment return, as well as macroeconomic factors)”;*

- “financial regime based on fully-funded individual accounts (FFI)”; and
- “private administration, although it might also be multiple (public and private mixed)”.

Ideological discussions which role player is in the best position to deliver a successful retirement system are unproductive. Technical aspects are, and should stay, central to reform considerations.

1.3. ASSESSMENT OF STRUCTURAL FEATURES OF RETIREMENT ARRANGEMENTS

1.3.1 Overview

This section provides a high-level review of the different claims, experiences and analyses of various issues raised by retirement reform. The purpose of the review is to decide whether a benchmark of structural features of a retirement system can be established.

1.3.2 Redistribution

A retirement system, depending on its construction, will involve one or all of the following potential distribution issues:

- Life-cycle transfers: from an individual in youth to their old-age;
- From young people to those who are retired;
- From males to females; and
- From rich to poor.

Public PAYG systems can include all four of the above, or just focus on life-cycle transfers. Private defined contribution systems essentially only offer life-cycle transfers. However, defined benefit retirement funds can offer elements of all four, but not as completely as a public system.

Unplanned redistribution is possible in all PAYG funds where the contribution and benefit formulae have left the fund with a shortfall. Non-structural reforms focus on this shortfall, by trying to engineer their coming together on the *planned* level of redistribution rather than leaving this aspect open-ended.

1.3.3 Funding versus Pay-As-You-Go

The demographic changes that impact on many industrialised countries’ PAYG public systems have raised the issue of structural reform, with a proposed switch to “funded” approaches. The assumption is that, somehow, a funded approach responds differently to demographic change.

Barr (2004, p.194-5) argues that the “widely held view that funded schemes are inherently ‘safer’ than PAYG is an example of the fallacy of composition. For individuals, the economic function of a pension scheme is to transfer consumption over time. But ... this is not possible for society as a whole; the consumption of pensioners as a group is produced by the next generation. From an aggregate viewpoint, the economic function of pension schemes is to divide total output between workers and pensioners – that is, to reduce the consumption of workers so that sufficient output remains for pensioners. Once this point is understood, it becomes clear why PAYG and funded schemes, which are both mechanisms for dividing output between workers and pensioners, should not fare very differently in the face of demographic change.”

Barr (2004, p.198) concludes that the only difference between PAYG and funded systems, given the fallacy of composition argument, is that output may be higher in funded arrangements. This argument is, however, based on the very controversial and disputed view that higher levels of investment, driven by higher national savings levels where funding replaces PAYG, lead to higher output. This is discussed in **section 2.3.7** below.

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1.3.4 Compliance

An argument in favour of structural reform is that the ownership of individual accounts in a private arrangement encourages regular contribution payments, based on the potential return on investment. However, there has been no evidence to support this claim (in fact, the evidence shows that there was actually less participation after a switch to structural reforms in Latin America. (Mesa-Lago, 2004, p.9). This is also the view of the Turner Commission (2005).

1.3.5 Competition

Private markets have the advantage that competition is likely to cause better operational efficiency. However, evidence from the Latin American country reforms shows that market concentration can occur, leaving markets uncompetitive and inefficient. (Mesa-Lago, 2004, p.9).

“It could be argued that if the three biggest administrators are the best, concentration is not a bad thing. But a study of Chile shows that, systematically in the long run, the three biggest administrators have not charged the lowest commissions and paid the highest investment returns. The insured have chosen the three administrators, even though they are not the best, for three reasons:

- *“most of the insured lack the needed information and/or skills to make an educated decision;*
- *“the insured has been lured by advertising, which usually sells an image of security and reliability but fails to provide key information to the insured on the commission charged and the real return in order to identify the best providers; and*
- *“many insured have been affiliated by salespersons who receive a commission from the administrator for each affiliate they transfer and*

whose interest is to switch as many insured as possible. In Chile there was one salesperson per 160 active contributors in 1998, but that ratio has declined significantly since then; in Argentina there was one salesperson per 225 active contributors in 2001. Often salespersons bribe affiliates with gifts to switch administrators; some countries have banned such practices.”
(Mesa-Lago, 2004, p.10).

The clear warning from Latin America is that countries with small markets should not depend on competition to create efficiencies. This will even be the case with relatively large markets. An important part of the problem comes from consumers having to rely on questionable middlemen to advise them on what to do.

1.3.6 Labour Markets

The impact of retirement contributions on labour markets, particularly when contributions are not voluntary, comes from the potential view that these are a form of tax rather than deferred income. It is possible that mandatory arrangements that are badly structured, could result in unnecessary cross-subsidies that will be seen as a tax. However, in those cases where reasonable cross-subsidies are in place and where income-smoothing is the primary objective, this problem will be mostly a perceptual view, and should be mitigated through communication.

The Turner Commission (2005) notes that *“attitudes to compulsion are ambivalent. While many people say they want to “have to save”, many respond adversely to the idea of compulsory savings. And there is a danger that compulsory savings contributions may be seen as equivalent to taxation, reducing people’s willingness to support an adequate system of flat-rate state pension provision.”*

On the other hand, if contributions are not required by law, coverage seems to be less. It would seem to be necessary to require contributions by law.

The Turner Commission felt that pension coverage in the United Kingdom will become more and more inadequate unless effective action is taken. When mandatory participation was reduced, it was not replaced by voluntary take-up. *“Looking forward the state is planning to play a reduced role in pension provision for the average pensioner. Policy has been based on the assumption that private provision will grow to offset this decline. ... But voluntary private provision is not growing: rather it is in irreversible decline. Employer’s willingness voluntarily to provide pensions is falling and initiatives to stimulate personal pension saving have not worked.”*

The view that mandatory contributions are a tax rather than forced savings may be due to the absence of choice. It can be alleviated by providing opt-out arrangements where mandatory contributions to a state fund are required. An opt-out arrangement means that individuals can choose whether to use a state or a private fund for their retirement provision. Such arrangements would have to ensure that the state fund is designed to be protected from the impact of these decisions. For instance, an opt-out arrangement would not be suitable for a PAYG defined-benefit state fund. However, it would work in a funded defined-contribution state arrangement.

1.3.7 National Savings and Investment

Orszag and Stiglitz (2001, p.21) examine the validity of the claim that private defined contribution plans raise national savings by using a distinction between “pre-funding” in a narrow and in a broad sense. The former refers to asset accumulations against future projected payments, while the latter

refers to increases in ‘national savings’. It is pointed out that pre-funding in the narrow sense does not imply pre-funding in the broader sense.

“If individuals offset any contributions to individual accounts through reduced savings in other forms, then total national savings are unaffected by the accounts. ... Furthermore, narrow pre-funding has no macroeconomic implications, only broad pre-funding offers potential macroeconomic benefits.” (Orszag and Stiglitz (2001, p.21-22).

No direct link can therefore be assumed between pre-funding a pension arrangement and changes in national savings levels, with a high possibility of replacement effects. If it is funded from higher levels of government debt, national savings remain unchanged. Only the structure of national debt has changed, with implicit debt becoming explicit. There are basically no macroeconomic effects.

Holzmann (2001, p.58) qualifies the above position by noting that where the shift to a funded approach involves external factors such as capital market development, there could be an advantage. This is, however, not an important issue for South Africa, given its well-developed capital markets.

Barr (2004, p.204) strongly questions the link between increased ‘savings’ and raised output.

“There are not one, but three links in the argument that future output will be higher with funding rather than PAYG:

- *“funding leads to a higher rate of saving in the build-up period than PAYG;*
- *“this higher saving is translated into more and better investment; and*
- *“this investment leads to increased output.”*

“None of the three links necessarily holds. The evidence on the first ... is mixed. On the second,

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increased savings does not necessarily lead to new investments So far as the third link is concerned, the objective is to channel resources into their most productive investment use. But it cannot be assumed that pension managers make more efficient choices than other agents. More generally, the declining growth performance of the Communist countries over the 1970s and 1980s, despite very high levels of investment, makes it clear that the volume of investment is not the sole determinant of growth – its quality is also of central importance.”

“As with the second link, there is also an important macroeconomic argument. The claim that higher savings contributes to growth is of dubious relevance in a small open economy, since investors can borrow internationally. Thus higher savings by people in countries such as Poland, New Zealand, South Africa, or Chile might well translate into higher income for them in the future, but will have little effect on the level of investment in those countries. The argument is less true in the USA, whose international borrowing, because of its size, will drive up world interest rates. Thus the USA (from which most of the literature emanates) is a special case.

“All three links have to hold before it can be asserted that funding will lead to greater increases in output than PAYG. At best the assertion is not proven.”

After a review of the evidence of capital market build-up and the impact of national savings on Latin American countries Mesa-Lago (2004, p.21) concludes that: *“Capital accumulation has been quite considerable, though it varies in the nine countries according to how long the reform has been in operation and other factors. In 2001 it reached 55% of GDP in Chile, the country with the*

oldest reform (21 years), and from 4% to 11% in the remaining countries (less than 1% in Costa Rica because the system has just started). If historical trends persist, the fund will grow and so its ratio to GDP. The effect on national savings is difficult to measure and there are contradictory results. But three studies on Chile, the only country with enough experience to bear analysis and whose reform has been amongst the most successful, deducted fiscal costs from private pension savings as annual average of GDP and showed a negative result in the first 16 years. These results advise against undertaking a pension reform with the main objective of increasing national savings; the goals of the reform should be others.”

Raising national savings levels through retirement reform appears to be an illusion at best. A concern is the possibility that domestic growth could in fact be negatively affected. In small open economies, the national savings levels are not improved by funding and, even if they were, it would not be necessary, as savings can in any case be accessed on international capital markets.

Furthermore, limiting the variety of agents responsible for investment decisions increases the risk of poor investments and, as a result, poor returns. In a small open economy increased savings will not necessarily be applied to the domestic economy as the choice of where to invest will be affected by rates of return internationally, which could offer better prospects in the short-term.

Based on the above, no sound argument can justify structural reform on the basis of increased output arising from higher likely national savings. In fact, the reverse is as likely: lower net national savings levels, reduced returns from poor investments, and the increased risk from limiting the pool of investing agents.

1.3.8 Regulation of Private Markets – supervision and governance

Governance failures in certain public systems have become one of the biggest motivations for structural reform. However, management in private markets is an equally great concern, as this largely depends on the quality of the regulatory framework. Countries that have management problems in operating state funds normally have weak oversight of private markets, which seems to show that management concerns are not avoided.

“Privatisation has been motivated by the poor quality of services provided by government social security institutions. Competition in private sector management is thought to be more efficient and lead to better services than monopolistic management by government. Experience, however, has shown that the administrative costs of government schemes are often less than for private sector management.” (Gillion, 2000).

Furthermore: *“Experience with private management of pension funds has shown, however, that regulatory safeguards are needed to protect against private sector theft of funds.” (Gillion, 2000).*

Governance is primarily a design issue, and not merely an issue of competition. The governance structure of a publicly sponsored retirement arrangement could be both cheaper to administer and safer for retirement funds than private funds. Great caution should therefore be exercised in relying on weak arguments and generalisations to curb publicly-sponsored retirement systems.

It is necessary to regulate private pension markets effectively in order to provide retirement funding successfully and safely through private markets. The competence of the supervisory authority, or regulator, is very important. This authority should:

- Be operationally independent;
- Have a proactive, well financed and professional staff;
- Vet applications for licensing; and
- Collaborate with other regulators.

(World Bank, January 2005, p.16)

Regulatory structure is also important. For instance, should there be a single integrated financial regulator that oversees all financial institutions and arrangements including retirement funds, or a special purpose retirement fund regulator, as in Chile? A specialist regulator has the advantage of focus and dedicated expertise. The integrated approach can ensure a big-picture treatment of an environment, but has the disadvantage that it will not respond as easily to the needs in terms of the regulation of the retirement environment.

Making sure that retirement funds are effectively managed depends on the quality of regulatory oversight and structural rules in place. Given the Enron scandal and a number of other high-profile bankruptcies, concerns have been raised about the adequacy of existing regulatory provisions to protect the private pensions of individuals. In response to this the OECD (Organization of Economic Co-operation and Development) has published a series of recommendations on core principles for the regulation of occupational pension funds (OECD, 21 July 2004). The full text of these recommendations is provided in the **annexure** to this report.

Important management considerations affecting occupational funds include:

- deciding on board composition;
- independence from the employer as sponsor;
- voting rights of board members;

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- removal of conflicts of interest;
- ensuring the independence of advice provided by external advisors;
- specifying the duties and responsibilities of the board; and
- the level of personal liability in cases of fraud and incompetence.

Open funds also require particular oversight and governance requirements. *“In open funds managed by management companies, the governance rules apply to the management companies themselves, since the funds typically have no boards. The management companies must be exclusively dedicated to pension fund management; they cannot delegate or subcontract their management functions, and they can manage only one pension fund. The quality of governance depends in great part on the quality of the rules applicable to the boards of management companies, that is, rules concerning self-dealing and conflicts of interest, the responsibility of board members, and the exposure of board members to personal liability. In countries where open funds have boards (Hungary, for example), the management company typically dominates and appoints the board and plays a more limited role in practice. In this case the management company will be critical in determining the quality of governance.”* (Rocha et al, 2001, p.185).

Figure 1 provides a broad outline of the central elements of a supervisory and governance framework for private retirement funds. At the supervisory level, apart from a requirement for competence, there is also a need for full independence.

“When faced with a crisis in the financial sector, policymakers have often brought pressure on bank regulators to engage in policies of forbearance or to delay interventions. The result has often been to ultimately make problems deeper or more costly when they are finally addressed.” (Rocha et al, 2001, p.206).

The supervisory function can be broadly categorised into “prospective” and “retrospective”; with the former applying to measures that prevent management problems in advance, and the latter referring to measures that deal effectively with problems when they occur.

Different regulatory and governance approaches may be needed between “occupational” and “open” retirement funds, given their differences. However, many of the governance rules and member rights are effectively the same, but applied differently to make provision for structural differences between the two forms of arrangement.

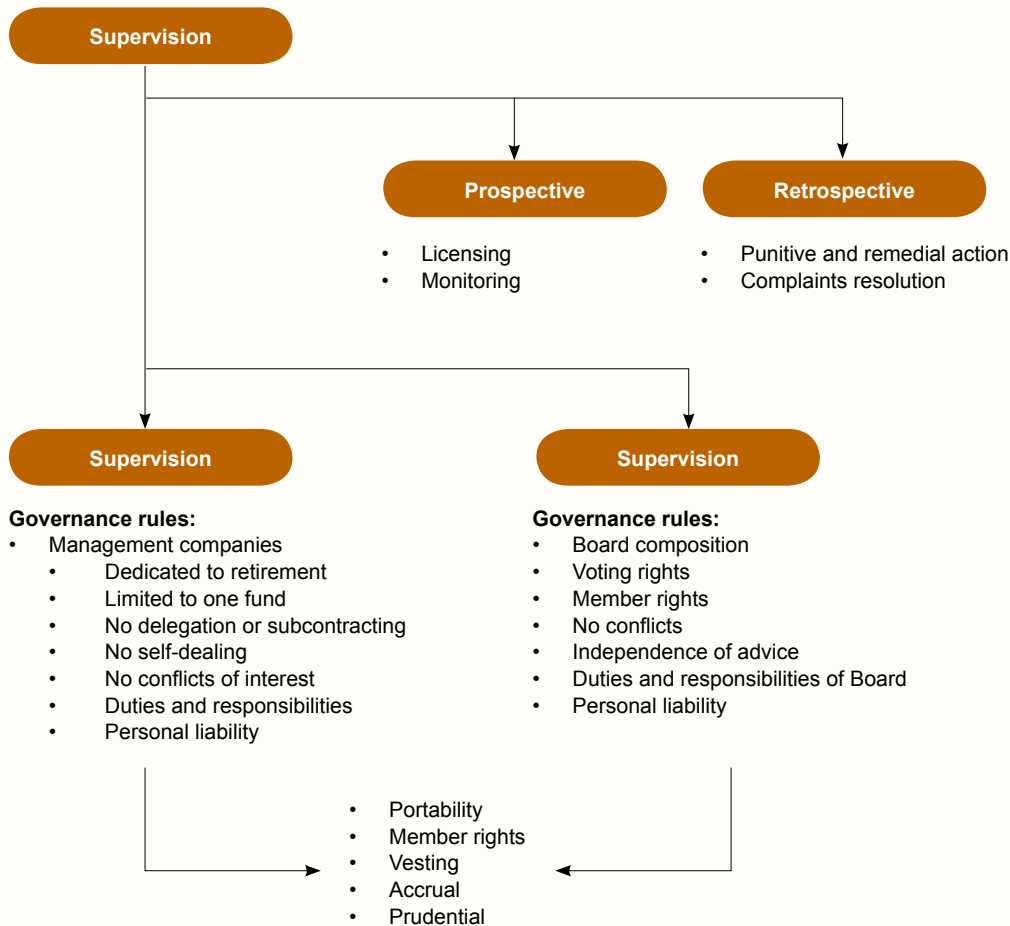


Figure 1: Outline of the Governance Framework Required for Private Retirement Funds

1.3.9 MEANS TESTS – DEALING WITH POVERTY

The use of means tests for access to certain forms of social security benefit can increase administrative costs a great deal, encourage corruption, wrongly exclude some income groups, encourage a poverty trap, and result in stigmatisation.

Two approaches can be identified for dealing with poverty: categorical schemes and non-categorical schemes.

“The former stress the causes of poverty, and institute programmes for specific groups. Historically it was

thought that most people would be self-supporting through work, through insurance against income loss due to unemployment or sickness, or through savings and other forms of income smoothing; and that those who fell outside these groups could be categorized into the disabled, the blind, etc. Underlying this approach is the distinction between the ‘deserving’ poor (e.g. widows with young children) and the ‘undeserving’. Such thinking lay behind the Poor Law, and permeated much of the 1930s New Deal legislation in the USA. The Beveridge Report (1942:124-5), though liberal in its attitude, distinguished eight ‘reasonable’ causes of poverty.” (Barr, 2004, p.232).

“Non-categorical schemes, in contrast, regard recipients as a spectrum that includes the self-supporting, the very poor, and large numbers in between. Such schemes concentrate on outcome rather than cause, and classification is made only in terms of need. The approach is attractive because there are few gaps through which ‘difficult’ cases can fall, but has the disadvantage of requiring a means test of one form or another.” (Barr, 2004, p.232).

One of the state’s main responsibilities in relation to retirement is stopping poverty in old age. The design of a pension fund framework for any country can deal with this objective through the use of a means tested benefit, or an approach that gets the same results without the need for a means test.

The Turner Commission proposals for the UK focus on the elimination of the means test because it doesn’t encourage savings. This would involve the conversion of the state PAYG pension into a pure flat rate pension (i.e. no earnings-related factor) funded from tax or National Insurance. This would ensure that these resources are focused on:

- *“Ensuring that all people are kept out of poverty in retirement;*
- *“Making the system as non-means-tested as possible; and*
- *“Reducing present problems in the treatment of those with interrupted paid work records and caring responsibilities.” (Turner Commission, 2005).*

The above is very much a ‘negative income-tax’ approach to funding a basic pension benefit. Although use of negative income-tax arrangements may be administratively simple and remove wrongful behaviour they create the impression of very high tax rates. However, if the benefit, in this case a ‘basic retirement benefit’, is relatively low in cost

compared to other forms of social security, it could reduce this problem since the financing requirement is less than if all social security benefits were arranged in this way.

1.4. TAX REGIME

“The tax treatment of pension contributions and benefits has important implications for fiscal policy, individual decisions regarding savings and consumption, and equity. A generous tax system could encourage private saving, but it would do so at the cost of foregone tax revenue (reduction in public sector saving). Adverse redistribution may also result if high-income individuals benefit more from tax exemptions than low-income individuals.” (Robalino, 2005, p.211).

A significant range of tax subsidy configurations, applicable to both mandatory and voluntary systems, exists internationally. Tax subsidies are more formally referred to as Tax Expenditure Subsidies (TES). Such subsidies take one or other of the following forms:

- Tax on retirement contributions (front-loaded);
- Tax on investment returns; and
- Tax on benefits (back-loaded).

Pension tax regimes involve combinations of the possible taxes, e.g. EET (exempt, exempt, tax) where contributions are exempt, investments are exempt, and benefits are taxed. **Table 2** shows the range of regimes with a crude illustrative example of their relative impacts. Whitehouse (2001) regards the EET and TEE as the same (in the crude example) and describes them as “expenditure taxes”. The TTE and ETT regimes are also regarded as mostly the same, and are referred to as “comprehensive income taxes”.

The comprehensive tax regime implies that savings are regarded in the same way as any other goods. The expenditure tax, on the other hand, is neutral between present and deferred consump-

tion. A disadvantage of the comprehensive tax, however, is that it over-taxes savings when inflation occurs, as the tax applies to nominal rather than real returns. (Whitehouse, 2001, p.2).

| | Expenditure Tax | | Comprehensive Tax | |
|--------------|-----------------|-----|-------------------|-----|
| | EET | TEE | TTE | ETT |
| Contribution | 100 | 100 | 100 | 100 |
| Tax | - | -25 | -25 | - |
| Fund | 100 | 75 | 75 | 100 |
| Returns | 61 | 46 | 33 | 44 |
| Final fund | 161 | 121 | 108 | 144 |
| Tax | -40 | - | - | -36 |
| Net pension | 121 | 121 | 108 | 108 |

Source: Whitehouse, 2001, p.1

Table 3 summarises the tax regimes for 30 countries.

| Better than expenditure tax | Expenditure tax | Between expenditure and comprehensive income tax | Worse than comprehensive income tax |
|-----------------------------|-----------------|--|-------------------------------------|
| Australia | Argentina | Denmark | Belgium |
| Austria | Canada | Finland | Iceland |
| Czech Republic | Chile | France | Japan |
| Hungary | Columbia | Norway | New Zealand |
| Ireland | Costa Rica | Sweden | |
| Korea | Germany | | |
| Portugal | Luxembourg | | |
| United Kingdom | Netherlands | | |
| | Poland | | |
| | Spain | | |
| | Switzerland | | |
| | United States | | |
| | Uruguay | | |

Source: Whitehouse, 2001, p.2

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In unfunded mandatory systems contributions are normally tax exempt but benefits are fully taxed. The same approach is used for funded systems, with the interest earned taxed very little if at all. (Robalino, 2005, p.211).

“For retirement income, the consumption-type tax approach is thus applied, which eliminates distortions on inter-temporal consumption and savings decisions. This is the appropriate treatment of retirement income.” (Robalino, 2005, p.211).

However, while there is agreement on the taxation of mandatory funds, in practice there is no consistent approach to voluntary systems. (Robalino, 2005, p.211).

“For some economists, preferential tax treatment (that is, consumption-type taxation) should also be applied, within limits, to voluntary schemes in order to encourage the take-up of these schemes and to allow governments to play a more active role in regulation and supervision. For other economists, such tax treatment does little to increase overall individual saving, and an increase in take-up reflects simply a substitution for other forms of saving. Even worse, the income effect of the preferential tax treatment may even reduce individual and government saving. Still, even though consumption-type taxation may not increase saving and may not deepen financial markets, it does change the composition of financial intermediation favoring long-term funds. This, in turn, reduces the refinancing risks of governments, banks and enterprises and reduces the leverage of enterprises, making them more resilient to shocks.” (Robalino, 2005, p.212).

“A problem with consumption-type taxation under a progressive tax system is that the well-off benefit the most, since the low-income workers with insufficient income to pay taxes do not benefit at all. Hence, an alternative approach is for government to grant matching subsidies to contributions

to voluntary retirement plans. Moreover, using matching subsidies instead of tax preferences permits the design of a well-targeted, equitable, and transparent program. Such a program would be available to nontax payers, which would increase coverage rates by attracting the self-employed and informal sector workers to voluntary pension plans.” (Robalino, 2005, p.213).

Whitehouse (2001, p.3) questions the reasons for generous tax treatment of retirement savings.

“There are three arguments for taxing pensions more generously than other kinds of savings

- *to ensure people have a standard of living in retirement close to when they were working*
- *to cut the cost of social-security benefits for pensioners*
- *to increase long-term savings*

“The first argument is paternalism. Without an incentive, people will be myopic and fail to make sufficient provision. This might well be true, but the tax system is not the way to put it right. Even with the incentive, people may not save enough. It is hard to define what is a ‘sufficient’ retirement income, beyond a reasonable minimum. The best way of being paternalist is mandating minimum retirement savings, either through state provision (the ‘first pillar’) or compulsory contributions to private funds (the ‘second pillar’).

“The second argument is ‘moral hazard’: if the state ensures an adequate income anyway, there is no reason for people to provide for themselves. Again, the tax system is not the best way of avoiding the fiscal impact of moral hazard. Also, the tax incentive cuts revenues.

“Increasing savings, the final factor, has been the subject of academic dispute. Whether the ‘success’ of new kinds of savings plans, RRSPs in Canada,

personal pensions in the United Kingdom and individual retirement accounts in the United States – is a result of substituting these new plans for other kinds of savings is difficult to ascertain. And the budgetary cost of incentives can mean that national savings fall, even if household savings increase. The OECD concludes: ‘There is no clear evidence that the level of taxation, along with other factors affecting the rate of return, does generally affect the level of saving’. With no clear answer, increasing savings should not be an objective for pensions tax policy.” (Whitehouse, 2001, pp. 3-4).

1.5. ADMINISTRATION COSTS

1.5.1 Overview

As discussed briefly in **section 1.3.5** administration costs are an important factor in privatised retirement fund environments. There is no strong evidence that privatised retirement markets are more efficient and cost-effective than public retirement provision, when the additional administration costs are taken into account.

Part of the problem comes from the contradictory effects of insufficient economies of scale for competitive markets, and the lack of competition where markets develop these economies.

Other factors are more difficult to deal with: where markets are not transparent consumers are unable to optimise their decisions, and are easily misled by various marketing techniques; and poorly regulated markets allow basic conflicts of interest to exist, resulting in fraud and corruption. All these factors lead to higher costs and lower returns.

This section reviews the issue of administration costs associated with various retirement regimes.

1.5.2 Forms of administration charge

The fees charged on long-term financial arrangements can occur many different ways, with very different effects on their ultimate value. In the case of pensions, the following exist:

- Fixed sum payable up front;
- Fixed sum payable at the end of a period;
- On-going fees per period;
 - Fixed fee per period;
 - Percentage of contribution;
 - Percentage of assets in the fund.

The above can be applied individually or in combination, making it difficult to study the impact on the value of the pension at any given in time. The most useful measure is therefore a calculation based on a full lifetime. (Whitehouse, 2001, p.11).

Whitehouse (2001, pp.13-14) proposes four measures of charges for pensions:

- **Reduction in yield:** “shows the effect of charges on the rate of return, given a set of assumptions about the rate of return, the time profile of contributions and the term of the plan.”
- **Reduction in premium:** “shows the charge as a proportion of contributions, again for a set of assumptions about investment returns etc.”
- **MP1 (managed portfolio):** “is the price of a managed portfolio that yields the market return, excluding charges, on £1.”
- **Charge ratio:** “defined as one minus the ratio of the accumulation net of charges to the accumulation without charges”.

Whitehouse (2001, p.25) qualifies the use of any of the above measures indicating that no simple

measure can accurately reflect the different fees charged for financial products. *“Our concern should therefore be to minimize the loss of precision in this process of simplification.”*

“When comparing funds or systems which rely on different types of charge, reliance on a single measure can be misleading, and the best approach is to use both the charge ratio and the charge as a proportion of assets.” (Whitehouse, 2001, p.26).

The analysis provided below focuses on showing the charge ratio and reduction in yield indicators of performance.

1.5.3 International comparison

The mandatory portion of funded retirement systems indicates lower overall costs and better value for money than voluntary retirement systems. **Table 4** summarises the results for a number of countries including South America, OECD and Transition economies. The charge ratio shows which part of any final pension value has been lost to charges. Using this measure Bolivia shows the lowest overall charge rate of 9,8% compared to Australia’s master trusts, which are individual funded pensions and come out the worst at 35,5%.

The Bolivian system is significantly different to other arrangements and is based on a duopoly arrangement in terms of which two funds were allocated members on the basis of an international tender. The period of the contract was set for five years.

The Australian (industrial) funds are group schemes established in terms of industrial bargaining arrangements. *“Trade unions pushed for a low-cost form of pension provision. These funds have a mutual structure, with trustees drawn from participating employers and employees. They have essentially a captive membership, so there is little need for marketing and no need for a sales network.”* (Whitehouse, 2001, pp.32-33).

The administrative costs of industrial funds differ markedly from the ‘Market Trusts’ which are mostly profit making financial service companies. These funds market extensively and maintain distribution networks which increases their cost relative to non-competing group schemes. Therefore, while the charge ratio for an industrial arrangement is around 11,2%, that of Market Trusts is at 35,5%, which shows a major reduction in value.

The UK also has very high charge rates, also with much difference in rates, given the large number of arrangements and charging mechanisms. However, as in Australia, collective scheme arrangements that do not compete for market share perform much better than for-profit funds.

Whitehouse (2001) recommends caution in drawing inferences from the inter-country differences within Latin America given the different maturity levels of their systems. Costs seem to reduce over time as systems mature. Chile is an example, where its charge ratio has reduced from 30,3% in 1987 to 22,5% by 1992.

Table 4: International comparison of pension fund charge levels by country for mandatory and voluntary systems

| Countries | Reduction in yield | Charge ratio | Source |
|---------------------------|--------------------|------------------------|----------------------------|
| Mandatory Systems | | | |
| Bolivia | 0.46% | 9.8% | Whitehouse, 2001, p.30 |
| Australia (industrial) | 0.51% | 11.2% | Whitehouse, 2001, p.32 |
| Kazakhstan | 0.55% | 11.5% | Whitehouse, 2001, p.45 |
| Columbia | 0.65% | 14.0% | Whitehouse, 2001, p.28 |
| Uruguay | 0.72% | 14.7% | Whitehouse, 2001, p.28 |
| Chile | 0.88% | 16.2% | Whitehouse, 2001, p.28 |
| El Salvador | 0.85% - 0.85% | 17.0% | Whitehouse, 2001, p.28 |
| Poland | 1.05% - 0.90% | 17.1% - 20.5% | Whitehouse, 2001, p.44 |
| Hungary | 1.60% | 17.0% - 28.0% | Rusconi, August 2004, p.67 |
| Peru | 0.96% | 19.0% | Whitehouse, 2001, p.28 |
| Argentina | 1.20% | 24.4% | Whitehouse, 2001, p.28 |
| Mexico | 1.39% | 24.5% | Whitehouse, 2001, p.28 |
| UK | | 15% - 33% (mean = 23%) | Whitehouse, 2001, p.38-9 |
| Australia (master trust) | 1.90% | 35.5% | Whitehouse, 2001, p.32 |
| Voluntary Systems | | | |
| US TSP | 0.10% - 0.70% | 2.0% | Rusconi, August 2004, p.67 |
| Czech Republic | 0.90% - 1.20% | 14.0% - 18.0% | Rusconi, August 2004, p.67 |
| Italy (open funds) | 1.70% | 24.0% - 33.0% | Rusconi, August 2004, p.67 |
| UK personal pensions | 1.20% - 1.40% | 23.0% - 25.0% | Rusconi, August 2004, p.67 |
| Italy (personal policies) | 1.80% - 3.10% | 34.0% - 51.0% | Rusconi, August 2004, p.67 |
| US mutual funds | 1.80% - 2.00% | 31.0% - 34.0% | Rusconi, August 2004, p.67 |

1.5.4 Economies of scale

One important consideration in pension system design is whether economies of scale are an important factor in determining charge ratios. If economies of scale do reduce average costs of member and asset management, larger schemes are better than smaller schemes. If sufficiently important, size may matter more than competition in delivering efficiencies.

Whitehouse (2000, p.28) examined directional differences between weighted and unweighted mean costs in Latin American countries. The

results varied at the level of funds build-up at which he examined them, suggesting that there is no general trend. The fact that there is no clear systematic relationship, however, did not take into account agency problems, which may reduce the motivation of any fund to reduce costs in response to market pressure. Other studies have in fact found a relationship.

The following sample of results from different studies is offered by Whitehouse (2000, p.57-58):

- “Turner and Beller’s (1989) study of pension funds in the United States found economies of

scale until funds reached \$75 million in assets; thereafter, administrative costs as a proportion of assets remain constant”.

- *“James, Vittas and Smalhout (1999) look at mutual funds in the United States. Their regression analysis suggests that the fall in costs comes to a halt between \$20 billion and \$40 billion of assets under management. Collins and Mack (1997), in contrast, find a rather lower minimum efficient size”.*
- *“Dermine and Roller (1992) suggest a minimum efficient size in the French mutual fund market of only \$0.5 billion”.*
- *“OSI, the management consultants, concluded that 0.5 million members would be sufficient to achieve available scale economies in the provision of stakeholder pensions in the United Kingdom (Timmins, 1999). With 10.5 million personal pensions in the United Kingdom, even a minimum efficient size of 0.5 million members leaves room for a dozen or so providers.”*
- *“The Australian Prudential Regulatory Authority (1998b) finds evidence of economies of scale in administration of the superannuation guarantee. ... this effect is stronger for funds using external rather than in-house investment managers. External administration costs about 1.5 times per member for the smallest funds, but is markedly cheaper for funds with more than 1,000 members. This is surprising, because managers can achieve economies of scale even by pooling together several small firms’ funds. Perhaps this result reflects greater competition among external managers for larger accounts.”*

Whitehouse (2000, p.58) suggests that the evidence is unconvincing and conflicting, and that this is an area for future research. It is strange, however, that despite the obvious importance of such work so

little research has been done. Definite information on economies of scale will affect:

- decisions on pension system design;
- trade-offs between regulation and competition;
- minimum fund size requirements; etc.

It is, however, hard to believe that economies of scale do not exist. The challenge is rather to assess at what level they are maximized.

1.5.5 Concluding remarks

If fee charges are too high, the value of retirement, as opposed to other savings options, declines. Where funded systems are required by law, it is essential that the optimal funding framework is adopted. This is especially important as contributors are forced into these savings.

A review of the international experience shows that compulsory systems making use of private funds have variable costs, with high costs in countries such as the UK and Australia, both of whom have mature systems. The review does show that reasonable charge ratios have been achieved in certain Latin American countries and in transitional economies.

Systems that rely on competition between for-profit retirement funds as their compulsory pillar tend to experience the lowest returns (i.e. the highest charge rates), similar to the general experience with voluntary pillars.

The new approaches followed in Bolivia, in which a tender system allocated members in the compulsory pillar to two bidders, is interesting. The contracts could be re-tendered every five years, creating a form of ‘longitudinal’ competition that seems to have kept costs really low while not creating any discouragement to achieve good investment returns.

With the complexity of different fee structures on the final pension, consumers are at a significant disadvantage when trying to decide which fund to join. This lack of information will reduce the consumers' sensitivity to price in choosing a retirement fund, for the simple reason that they cannot compare prices. At the very least, making the true cost of all retirement funds apparent to consumers should be considered.

1.6. COMPONENTS OF A 'BEST-PRACTICE' RETIREMENT SYSTEM

1.6.1 Overview

This section provides a view, based on international experience, of a best practice retirement system framework for a developing country. The exercise is done with reform of the South African system in mind. These will be taken into account in the report outlining final recommendations. This discussion tries to provide a high-level guiding framework for thinking about retirement reform.

1.6.2 Requirement for government intervention

A key question is whether Government has any role in ensuring retirement provision for its citizens. Although almost all developing and industrialised countries have drawn the conclusion that there is a role for Government in ensuring retirement provision for its citizens, the reasons should still be made as explicit as possible.

The central reason for Government intervention arises from the fact that, in the absence of government influencing retirement provision, protection becomes incomplete, with many families left with limited income in a period where they have ceased to be employable. This incomplete coverage tends to be biased against low and lower income groups, and females.

It is possible for a government to accept the tendency/trend toward incomplete protection, and the increased vulnerability of particular families, and to argue that it should not interfere. Clearly such a stand/position by Government would have little to do with issues such as market imperfections, and everything to do with values, such as the fact that no countries appear to have taken this decision. However, leaving the issue of values aside for now, the following needs to be resolved:

1. Is there a rationale/motive for the voluntary take-up of retirement?
2. Will any underlying rationale for voluntary take-up result in complete take-up?
3. If voluntary take-up is incomplete, what social effects/negatives arise? And, if found to be so, how should government tailor/design its response to these social negatives?

1.6.2.1 Rationale for voluntary take-up

Barr (2005) sees the demand for complete retirement provision partly as a response to uncertainty. It is, however, also a response to the certainty that everyone will get old and infirm if they prevail to old age. Whereas the certainty of old age establishes a rationale for saving (or consumption smoothing); the uncertainties, such as life expectancy and the possibility of early disability, etc. establishes a rationale for insurance.

"In a world of certainty, including certainty about one's life expectancy, consumption smoothing takes place through saving. In practice, however, people do not know how long they will live and so a mixture of saving and insurance (i.e. the purchase of an annuity) is generally more efficient. Thus a rational individual who dislikes/ seeks to avoid risk will join a pension scheme so long as its net cost does not exceed the value of the certainty he thereby derives." (Barr, 2005, p.193).

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Here is a more complete list of uncertainties relevant to retirement:

1. Life expectancy of breadwinner;
2. Life expectancy of spouse;
3. Income during periods of employment;
4. Periods of unemployment;
5. Timing of unemployment (e.g. is this close to retirement);
6. Occurrence of a disability to the breadwinner or spouse;
7. Devaluation of assets during times of economic turmoil (including inflation); and
8. Potential for extended family support during times of difficulty, including retirement.

As noted, a rational individual who dislikes risk would seek to reduce uncertainty, to a reasonable degree, given imperfect knowledge concerning the above. Clearly, the greater the wealth of an individual, the less concerned they will be as they can provide their own insurance against the various risks/contingencies. For the well-off, a failure to cater for these contingencies may result in a lower standard of living, but not poverty. For others, however, even those earning a relatively high income during their working life, could drop into poverty, with impacts on extended families or Government (where safety net programmes exist).

1.6.2.2 Imperfect take-up

If everyone were rational and faced with equivalent uncertainties, a private market would be sufficient to ensure that the socially necessary levels of retirement provide for those able to contribute. For those unable to contribute, however, private markets obviously prove useless.

However, leaving aside the issue of insufficient income, a voluntary market for retirement and associated insurance should be sufficient if the

consequences of irrational behaviour had no consequence for others. However, Barr (2004) suggests that to the extent that external costs are imposed on others, minimum levels of protection are required.

“The shortcoming in the voluntarism argument in this case is that it overlooks the external costs that non-insurance can impose on others. ... the major efficiency argument for compulsory membership is that uninsured losses due to unemployment, illness, or industrial injury may impose costs on others, including dependants such as spouses or children. ... But, quite correctly on efficiency grounds, compulsion is limited to insurance to cover the damage I might inflict on others. I can choose whether to take out insurance to cover my own care or person.” (Barr, 2004, p.173).

If the above argument is accepted, which it is here, and it is found that *voluntary markets* result in under-provision, then governments would, at least, be obligated to step in to ensure *minimum* levels of protection sufficient to cover the *external costs* imposed on society.

Evidence from mature markets such as the United Kingdom, demonstrate declining participation subsequent to reforms which reduced the reach of mandates. *“But voluntary private provision is not growing; rather it is in irreversible decline.”* (Turner Commission, 2005) (See section 3.6).

A further test for the success of voluntary markets can be seen in the take-up by informal economy participants and the self-employed. Given that mandatory systems cannot effectively reach these groups their behaviour can be seen as a test of voluntary market success through time. Mesa-Lago (2002) points out, however, that in Latin America, where there has been growing informality of the labour market over time, has seen no important improvements in voluntary participation.

“The large and growing self-employed, the main component of the so-called informal sector in Latin America, endures extremely low coverage; making coverage mandatory is not necessarily the solution because of low capacity to contribute and serious obstacles for enforcement.” (Mesa-Lago, 2002, p.7).

Holtzmann et al, (2001, pp.452-492) feel that voluntarism is not a sufficient condition to grow participation alone. If supported properly, however, it should lead to improved participation in systems with many insurance options.

“This relatively static picture of the trends [in Latin America, and particularly in Chile] in sector choice supports the assertion that the tighter link between contributions and benefits and the lower cost of formal-sector hiring brought about by pension reform may be a necessary, but insufficient, condition either for the formalization of the factors of production or to attract widespread participation in the new systems with many insurance options.” (Holzmann et al, 2001, pp. 452-493, p.460).

In a study by Holzmann et al, (2001, pp.452-493), the factors correlated with pension fund take-up in Chile and Argentina were examined. The following were positively correlated with retirement fund participation:

1. Educational level (this is however an alternative variable for income attainment) (Chile and Argentina);
2. Income levels (Chile and Argentina);
3. Increases in age (in Chile the age over 40 was negatively correlated);
4. Marriage;
5. Additional elderly people in the household (Chile and Argentina);
6. Living in an urban area (in Chile living in the Greater Santiago Area was significant);

7. Contributions toward the health system (Chile and Argentina show a strong link);
8. Worker’s degree of formality (most significant variable in both Chile and Argentina);

Variables that were negatively correlated are:

1. Age over 40 (Chile only);
2. Additional children (Chile and Argentina);
3. Self-employment (Chile and Argentina);

From the above, income is important, with education clearly an additional indicator of life-time income. The degree of formality may have both a link to income as well as increased income uncertainty. Family circumstances may also impact through the income variable, as increased family size decreases per capita family income, and decreases the ability to earn.

On the question of whether voluntary markets suffer from market failure, Holzmann et al (2001, pp.452-493) raise three hypotheses, all of which are potentially valid, but not proven.

“However, that the only group of workers that are not forced to participate in the pension system largely chooses to participate less than salaried workers could be used as evidence to support a number of hypotheses: that agents are myopic (narrow-minded); that superior alternative strategies of minimizing income risk in retirement prevail; or that the self-employed are less myopic (are not narrow-minded) and pursue alternative strategies more suitable to their needs.” (Holzmann et al, 2001, pp. 452-493, p.477).

If agents are myopic, government would have a basis to intervene to protect society from external factors. If there were superior alternative strategies (i.e. both the latter hypotheses), it would be questionable whether government should intervene at all, even with tax subsidies.

The weak voluntary take-up may consequently be related to a number of factors:

1. Irresponsible individuals choosing not to make adequate provision for retirement;
2. Inter-generational transfers likely to occur through other channels, e.g. inheritances, which diminish the need for retirement provision;
3. Alternative, superior strategies exist for income smoothing and insurance;
4. Wealthy individuals need less income smoothing and can self-insure;
5. Intermittent employment of low-income groups working in the formal sector;
6. Large variations in income for the self-employed and people in the informal sector; and
7. Administration fees within the voluntary environment exceed the value of the smoothing and certainty purchased, due to marketing requirements and an inability to assess product quality.

Of the above, only (1) can be addressed through mandating minimum protection. It is questionable as to whether (2) or (3) should be addressed outside of the issue raised in (1). The other issues reflect systemic problems which can only be addressed through income transfers from higher-income groups to lower.

1.6.2.3 Government intervention

Governments currently respond to potential market failure in voluntary markets using both mandates and subsidies. Mandates are most effective in relation to the formal sector. Subsidy regimes are currently diverse and inconsistently applied across countries. Where no mandatory system is in place, tax subsidies (Tax Expenditure Subsidies) are often applied. However, the use of tax subsidies to substitute for a mandatory system is

heavily criticised. (See section 4). They cannot overcome the barriers low-income groups face, and disproportionately benefit higher income groups. Instead mandates and direct subsidies are preferred. Robalino (2005, p.312) specifically recommends “matching subsidies”.

To encourage low-income participation Costa Rica provides a fiscal subsidy to the self-employed with low income. A means-tested social assistance pension is offered in Argentina, Costa Rica, Chile, Uruguay, Brazil and Cuba. Countries of equivalent income that do not provide these supports consequently experience a higher occurrence of poverty. (Mesa-Lago, 2002, p.7).

The proposed best practice approach for government intervention to achieve appropriate coverage of retirement, and associated insurance, protection, is as follows:

1. A mandatory system of participation should be introduced, which includes both the *income smoothing and related insurance* elements for formal sector participants;
2. Mandates should only be imposed in relation to retirement provision in environments with acceptable levels of administration cost, which should be transparent;
3. A system of income cross-subsidies should be introduced to at least overcome unfair impediments related to administration and transaction costs;
4. A flat-rate universal, or income-tested, benefit should be provided on a non-contributory basis;
5. The flat-rate benefit should be offered in such a way that it does not discourage private savings – thus standard means tests should be avoided in favour of a universal benefit with a possibility that it can be recovered through taxes.

1.6.3 Objectives of a retirement system

Given that governments do have a role to ensure effective retirement coverage a set of objectives can therefore be established to guide decisions of a more specific nature concerning the appropriate retirement system. These objectives are provided instead of the World Bank framework of different pension options. A discussion on specific approaches linked to each objective is then provided in section 6.4.

1. **Objective 1 - Income protection to prevent poverty where savings will prove inadequate:** For people with inadequate income during their lifetimes, a safety-net income-protection system is required which ensures that no-one falls below the minimum level of income required to keep families out of poverty.
2. **Objective 2 - Income protection to prevent poverty due to the death or disability of a breadwinner:** For all people, and including those with inadequate income, a minimum level of income support is required to ensure that families and individuals are kept out of poverty as a consequence of the death and disablement of the breadwinner.
3. **Objective 3 - Third-party protection from the potential voluntary non-participation of breadwinners in retirement arrangements:** Third-parties must be protected from any external costs imposed by the potential non-participation in income-smoothing and insurance (for death and disability) by income earners; and which benefits must be responsive to the earnings of affected parties.
4. **Objective 4 - The system of minimum provision must apply equally to citizens and permanent residents, with the fair treatment of temporary residents:** Any system of minimum provision, both in respect of poverty prevention and earnings-related protection, must apply to both citizens and permanent residents, with temporary residents treated fairly where they are treated differently from citizens and permanent residents.
5. **Objective 5 - Government interference in voluntary arrangements over-and-above the minimum required protection, in the form of subsidies, should be limited to support aimed at removing impediments to access for the low-income group:** Voluntary income-smoothing and insurance arrangements which provide protection over-and-above the level required to minimise external costs on third-parties, should not be provided with preferential government support over-and-above other forms of savings and insurance; apart from subsidies to eliminate any unfair impact of administration costs on participation on low-income groups.
6. **Objective 6 - The full retirement framework should, without exception, be subject to adequate regulation, oversight and governance:** All organisations offering income-smoothing arrangements and insurance, whether through a government, quasi-government or private organisation, must be subject to a fully adequate system of regulation, oversight and governance.
7. **Objective 7 - Private markets must be regulated to fully empower consumers:** All private markets offering income-smoothing arrangements and insurance for death and disability must be fully transparent, with consumers empowered to the maximum possible extent.

1.6.4 Approaches to Retirement Provision by Objective

1.6.4.1 Overview

This section outlines specific elements of a 'benchmark' retirement system, by objective, based on the international evidence thus far.

1.6.4.2 Objective 1- Income protection to prevent poverty where savings will prove inadequate

The only feasible mechanism for this form of income protection is social assistance targeted at the lifetime poor. To prevent perverse incentives to the near poor not to save, and to eliminate the administrative costs associated with explicit targeting; means tested arrangements should be avoided. Instead, this particular objective can be satisfied through provision of a universal benefit coupled with a tax recovery mechanism.

1.6.4.3 Objective 2 – Income protection to prevent poverty due to the death or disability of a breadwinner

As with the framework for savings, income protection of this form can only be provided through social assistance. This system can be available to all citizens and permanent residents, subject to verification that the relevant risk/contingency has occurred. Disability grants provided only to the individual with a disability will prove inadequate if this is de-linked from the implications of the disability for the family as a whole and any dependants.

1.6.4.4 Objective 3 – Third-party protection from the potential voluntary non-participation of breadwinners in retirement arrangements

Governments should establish a system of minimum compulsory contributions for retirement and insurance sufficient to achieve at least a 40% (ILO standard) replacement rate. This tier would offer income-related benefits.

At least part of the mandatory system should involve compulsory participation in a defined benefit Pay As You Go (PAYG) tier. This tier should accomplish all the required cross-subsidies, all of which should be explicit and cater for long-term changes in population structure, employment levels and all other variables that could create unintended implicit cross-subsidies.

The PAYG tier need not be funded and should be delivered via a state-sponsored fund.

In addition to the PAYG tier, a compulsory payment should be made toward a defined contribution-type benefit. The defined contribution benefit should be offered by a state-sponsored provider. A voluntary option not to belong to this scheme should be permitted in favour of an approved (accredited) fund offered in the private sector.

The split between the PAYG and funded tiers of the mandatory system should be around 50:50.

Government should underwrite certain risks associated with the scheme with an option not to belong. Individuals who select private funds face the risk of fraud and management incompetence, which could leave them without effective minimum protection. However, if governments choose to underwrite these risks, perverse incentives may result, i.e. failures might be encouraged, and consumers may be less vigilant. To eliminate this possibility, government should not underwrite the full risk.

The private market offering alternative mandatory cover should be regulated to ensure the following:

1. The market is competitive and transparent;
2. The performance of all funds is fully revealed to consumers, including that of the state-sponsored option;
3. Governance structures of funds are regulated to minimise the possibility of fraud, corruption and conflicts of interest;
4. The funds permitted to offer products to the mandatory market have sufficient economies of scale to reduce administrative costs to a minimum;
5. Marketing costs should be limited through the provision of centralised information on the performance of funds, provided by a public entity (such as a regulator or the state-sponsored fund) which can offer easy comparison.

An alternative approach for the funded portion of the mandatory tier is to offer the investment management of the entire pool to a limited number of suppliers (such as the duopoly approach in Bolivia). This could involve an international tender to ensure that competitive bidding occurs without collusion. This would be most important in relatively small economies where a few financial institutions dominate the market. In this model, the basic administrative functions (member management, benefit payments, etc.) would be retained by a state-sponsored service provider. The tender would establish a five-year contract period, which may either be extended or re-tendered depending upon the performance of the investment service-providers.

Tax subsidies within the funded environment should be avoided in favour of explicit income transfers from higher-income groups to lower income groups.

1.6.4.5 Objective 4 - The system of minimum provision must apply equally to citizens and permanent residents, with the fair treatment of temporary residents

The system of minimum protection should apply to all citizens and 'near'-citizens. This should be made explicit to prevent unfairness. Temporary residents, including refugees, should also have explicit entitlements and fair procedures for qualification.

1.6.4.6 Objective 5 - Government interference in voluntary arrangements over-and-above the minimum required protection, in the form of subsidies, should be limited to support access for the low-income group

No rationale exists for government support for voluntary retirement environments over-and-above the mandatory tiers. Consequently, the tax regime should be TTT, with the purpose of reflecting personal income tax structure.

Tax subsidies are captured by high-income groups who will generally prefer to make their own savings arrangements. Governments should not use the tax system to artificially generate preferences for one or other type of savings arrangement.

Tax subsidies should not be used to encourage higher national savings rates; an issue now well established internationally.

1.6.4.7 Objective 6 - The full retirement framework should, without exception, be subject to adequate regulation, oversight and governance

A great deal of emphasis needs to be created to ensure the adequacy of the regulatory environment applicable to the retirement framework. Given that state provided arrangements are also subject to governance failure, these need to be subject to

independent oversight as much as private sector organisations.

Private funded arrangements will suffer from governance failure in the absence of oversight and consumer empowerment.

To achieve this end, a special-purpose regulator should be established to deal with retirement. This regulator should be independent of government and private influences. In addition to the regulator, an independent specialist court should be established to deal with all disputes.

The regulator should oversee both public and private sector arrangements. The specialised court should also deal with all matters relating to retirement provision.

1.6.4.8 Objective 7 - Private markets must be regulated to fully empower consumers

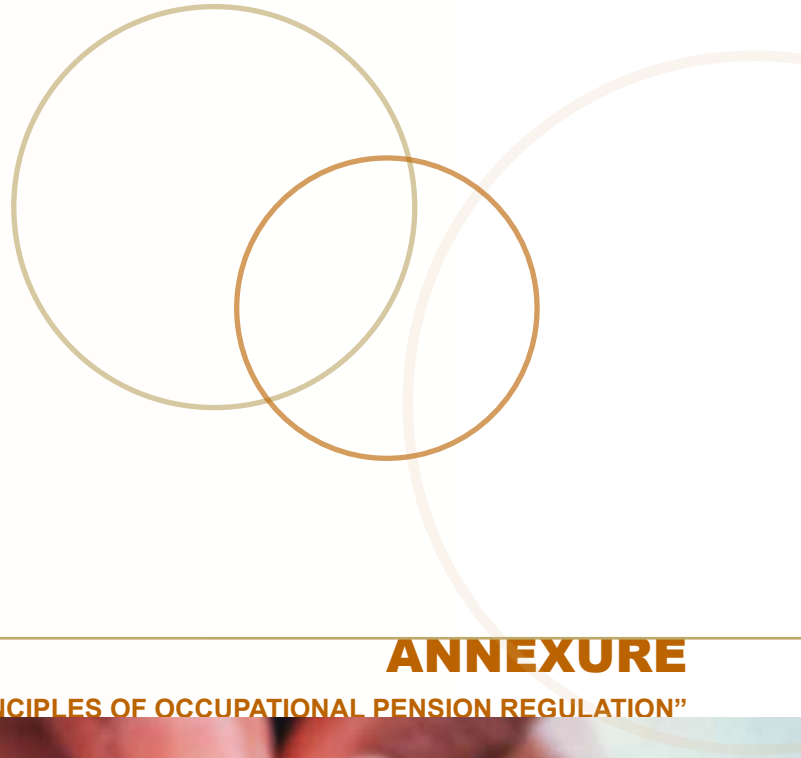
Consumers are only empowered to the extent that information imbalances are reduced and fraudulent practices are eliminated. The latter issue could result in consumers remaining disempowered despite having complete information concerning alternative options.

Consumers will not be empowered through a single intervention, and the environment to support this objective will have to be carefully considered. The following are the areas central to achieving this objective:

1. Governance structures need to allow for members of a fund to elect the majority of the directors/trustees at an annual general meeting.
2. Conflicts of interest need to be statutorily eliminated in respect of the following:

- a. Office bearers of funds;
 - b. Contractors to funds; and
 - c. Intermediaries offering advice to consumers and employers.
3. The rules of funds need to be explicit, approved by a regulator, and easily available to members and interested parties on demand.
 4. Members should be able to raise disputes within funds, which can be appealed to a higher authority.
 5. An independent regulator should exist.
 6. An independent specialised court should exist to hear complaints in respect of any part of the retirement system.
 7. Intermediaries (often referred to as brokers) offering advice in the market should do so on a fee basis and not receive commissions. Such intermediaries should also not receive payments from commercial interests in the market who would profit from misleading advice.
 8. Members should receive regular information on the status of their investments or accrual. This should at least be provided once a year.
 9. Funds should be required to maintain minimum information to ensure adequate contact can be maintained with members, dependants and next of kin.
 10. The relative performance of funds, including their administration costs, should be publicly reported and communicated to members.

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ANNEXURE

OECD - "CORE PRINCIPLES OF OCCUPATIONAL PENSION REGULATION"



OECD – “CORE PRINCIPLES OF OCCUPATIONAL PENSION REGULATION”

Recommendation on Core Principles of Occupational Pension Regulation

THE COUNCIL,

Having regard to Article 5 b) of the Convention on the Organisation for Economic Co-operation and Development of 14th December 1960;

Recognising the important role played by private pension systems in the retirement income systems of Member countries,

Recognising the specific nature of occupational pension arrangements and the role of employers as plan sponsors,

Recognising the need for appropriate regulation and supervision of occupational pension systems,

Recognising the desirability of establishing and maintaining set of core principles and guidelines for occupational pension regulation,

RECOMMENDS that Member countries, in establishing, amending or reviewing their occupational pension regulations in accordance with their own political, administrative and legal context, take due account of the Core Principles of Occupational Pension Regulation which are set out in the Annex to this Recommendation and form an integral part thereof.

INVITES Member countries, through their work in the Working Party on Private Pensions, to identify further good practices in occupational pension regulation.

INVITES Member countries to disseminate these principles and other good practices among public and private sector institutions that are involved in the management of private pension systems and

organisations that represent the interests of plan members and beneficiaries.

INVITES Non-Member economies to take due account of this Recommendation and, if appropriate, to adhere to it under conditions to be determined by the Insurance Committee.

INSTRUCTS the Working Party on Private Pensions to exchange information on progress and experiences with respect to the implementation of this Recommendation, review that information and report to the Council within three years of its adoption, or sooner, and, as appropriate, thereafter.

CORE PRINCIPLES OF OCCUPATIONAL PENSION REGULATION

Core Principle 1: Conditions for effective regulation and supervision

An adequate regulatory framework for private pensions should be enforced in a comprehensive, dynamic and flexible way (taking into account the complexity of the schemes) in order to ensure the protection of pensions plan members and beneficiaries, the soundness of pensions plans and funds and the stability of the economy as a whole. This framework should, however, not provide excessive burden on pensions markets, institutions, or employers.

A productive, diversified investment of retirement savings which spreads risk requires well-functioning capital markets and financial institutions. The development of advance-funded pension systems should go hand-in-hand with

a strengthening of the financial market infrastructure and regulatory framework (including the development of new financial instruments and new markets such as inflation-indexed markets and the improved functioning of retirement annuity markets).

Regulation should promote a level playing field between the different operators and take account of the usefulness of a functional approach. The fair competition should benefit the consumers and allow for the development of adequate private pensions markets.

- 1.1 Occupational pensions are subject to a set of legal provisions that regulate the main aspects of the operation of those plans.
- 1.2 The legal provisions promote the protection of pensions plan members and beneficiaries and the soundness of pension funds.
- 1.3 The legal provisions provide the necessary flexibility in order to permit the efficient operation of occupational pension plans;
- 1.4 The legal system allows the enforcement of financial contracts pertaining to occupational pensions. In particular, there is a body of ethical, professional and trained lawyers and judges, and a court system, whose decisions are enforceable. Comparable standards apply in cases where alternative dispute mechanisms exist.
- 1.5 Accounting standards for plan sponsors of occupational pensions are comprehensive, documented, transparent and consistent with international standards.
- 1.6 The legal provisions take into account the state of development of financial markets.
- 1.7 The legal provisions encourage efficiency in pension provision.

Core Principle 2: Establishment of pension plans, pension funds, and pension fund managing companies.

An institutional and functional system of adequate legal, accounting, technical, financial, and mana-

gerial criteria should apply to pension funds and plans, jointly or separately, but without excessive administrative burden. The pension fund must be legally separated from the sponsor (or at least such separation must be irrevocably guaranteed through appropriate mechanisms).

- 2.1 Legal provisions are in place relating to the establishment of pension plans and pension funds, including the legal form of pension funds that are established as independent legal entities and their governance structure.
- 2.2 Occupational pension plans have a formal, written charter or document, describing the plan's objectives and parameters, the duties and responsibilities of the governing body and the plan members' and beneficiaries' rights. In some cases, documents may reflect the extent to which various features of the plan are subject to collective bargaining. The legal provisions require also that by-laws, articles of association or trust instruments, describing their objectives and governance structure (including structure of responsibilities and fiduciary liability) are prepared for pension plans and funds jointly or separately.
- 2.3 The legal provisions require the legal separation of pension plan assets from the assets of the plan sponsor.
- 2.4 To the extent that the legal provisions require that dedicated providers (pension fund managing companies) manage autonomous pension funds set up as pools of assets or separately managed accounts, there is a licensing process for these specialised financial institutions.
- 2.5 The legal provisions identify the authority responsible for licensing of pension fund managing companies, define its powers and tasks, and prescribe in detail the licensing/registration requirements.

2.6 A minimum amount of capital is required for all pension fund managing companies.

Core Principle 3: Pension plan liabilities, funding rules, winding up, and insurance

Private occupational plans should be funded. While full-funding exists in principle for defined contribution plans, other types of plans should be subject to minimum funding rules or other mechanisms to ensure adequate funding of pension liabilities. Rules based on a winding-up approach may be promoted as a minimum level to complement the ongoing approach. Flexibility can be allowed for temporary limited under-funding under restricted circumstances.

Consideration should be given to the development of adequate but flexible requirements for minimum capital/guarantee in pension funds, taking account of the long term nature of their liabilities. Tax and prudential regulations should encourage a prudent level of funding. Private unfunded pay-as-you-go plans at individual company level should generally be prohibited.

Appropriate calculation methods for asset valuation and liabilities funding, including actuarial techniques and non-autonomous pension funds including book reserve schemes do not fall under the scope of the core principles.

Appropriate calculation methods for asset valuation and liabilities funding, including actuarial techniques and rules for the reduction of the value of an asset by prorating its cost over a period of years must be set up and based on transparent and comparable standards.

Proper winding-up mechanisms should be put in place. Arrangements (including, where necessary, priority creditors' rights for pension funds) should be put in place to ensure that contributions owed

to the fund by the employer are paid in the event of his insolvency, in accordance with national laws.

The need for insolvency insurance and/or other guarantee schemes has to be properly evaluated. These mechanisms may be recommended in some cases but in an adequate framework. Recourse to insurance mechanisms (group and reinsurance) may be promoted.

Measurement of pension liabilities in defined benefit plans

- 3.1 Legal provisions are in place requiring the funding of defined benefit occupational pension plan liabilities.
- 3.2 Legal provisions are in place that require the determination of defined benefit pension plan liabilities corresponding to the financial commitments or obligations which arise out of the pension arrangement, defined as the accrued benefit rights of pension plan members and beneficiaries in ongoing pension plans.
- 3.3 These legal provisions require the use of appropriate calculation methods, including actuarial techniques and amortisation rules that are consistent with generally recognised actuarial standards and methods.
- 3.4 The legal provisions require the identification and maintenance of a level of assets that is sufficient to cover ongoing plan liabilities. Legal provisions are in place for determining contribution requirements with respect to ongoing liabilities.
- 3.5 These legal provisions set out flexible methods for correcting a situation of underfunding – that is, where the value of pension assets is less than the value of the pension liabilities, with appropriate distinctions concerning the source of underfunding. Additional legal provisions may

be necessary to assure that additional funding is available in the event of the winding-up of a pension plan.

Winding Up

- 3.6 There are legal provisions in place regarding the allocation of plan assets and the responsibility for underfunding in the event of plan termination.
- 3.7 The legal provisions recognise the creditor rights of pension plan members and beneficiaries in the case of bankruptcy of the plan sponsor.

Core Principle 4: Asset Management

Investment by pension funds should be adequately regulated. This includes the need for an integrated assets/liabilities approach, for both institutional and functional approaches, and the consideration of principles related to diversification, dispersion, and maturity and currency matching. Quantitative regulations and prudent-person principles should be carefully assessed, having regard to both the security and profitability objectives of pension funds.

Self-investment should be limited, unless appropriate safeguards exist. Investment abroad by pension funds should be permitted, subject to prudent management principles.

Increased reliance on modern and effective risk management, industry-wide risk management standards for pension funds and other institutions involved in the provision of retirement income should be promoted. The development of asset liability management techniques should be given proper consideration.

Valuation of pension assets

- 4.1 The legal provisions establish a proper and disclosed basis for valuing pension assets.

Prudent Person Standard

- 4.2 The governing body of the pension plan/fund and other appropriate parties are subject to a standard of prudent behaviour, such that the investment of pension assets is undertaken with care, skill, prudence and diligence.

Portfolio limits

- 4.3 The legal provisions may include maximum levels of investment by category to the extent that they are consistent with the principles of diversification, dispersion, and maturity and risk management pursuant to which assets should be invested. The legal provisions shall not prescribe

a minimum level of investment for any given category of investment, except on an exceptional and temporary basis and for compelling prudential reasons.

- 4.4 Self-investment by those undertaking investment management of pension funds should be prohibited or limited, unless appropriate safeguards exist. Investment in assets of the plan sponsor, in parties related or affiliated with any pension entity or pension fund managing company is prohibited or strictly limited.
- 4.5 Investments in assets issued by the same issuer or by issuers belonging to the same group shall not expose the pension fund to excessive risk concentration.
- 4.6 Investment abroad by pension funds should not be prohibited.

Investment policy

- 4.7 The governing body or the party responsible for the investment management of pension assets is required to set forth and actively observe an overall investment policy.

Core Principle 5: Rights of members and beneficiaries and adequacy of benefits

Non-discriminatory access should be granted to private pensions schemes. Regulation should aim at avoiding exclusions based on age, salary, gender, period of service, terms of employment, part-time employment, and civil status. It should also promote the protection of vested rights and proper entitlement process, as regard to contributions from both employees and employers. Policies for indexation should be encouraged. Portability of pension rights is essential when professional mobility is promoted. Mechanisms for the protection of beneficiaries in case of early departure, especially when membership is not voluntary, should be encouraged.

Proper assessment of adequacy of private schemes (risks, benefits, coverage) should be promoted, especially when these schemes play a public role, through substitution or substantial complementary function to public schemes and when they are mandatory. Adequacy should be evaluated taking into account the various sources of retirement income (tax-and-transfer systems, advance-funded systems, private savings and earnings).

Appropriate disclosure and education should be promoted as regards respective costs and benefits characteristics of pension plans, especially where individual choice is offered. Beneficiaries should be educated on misuse of retirement benefits (in particular in case of lump sum) and adequate preservation of their rights. Disclosure of fees structure, plans performance and benefits modalities should be promoted, especially in the case of individual pension plans.

Access to plan participation, equal treatment and entitlements under the pension plan

5.1 Employees have non-discriminatory access

to the private pension plan established by their employer. Specifically, regulation aims at avoiding exclusions from plan participation that are based on non-economic criteria, such as age, gender, marital status or nationality. In the case of mandatory pension plans, those plans that serve as the primary means of providing retirement income, and those that are significantly subsidised by the state, regulation also aims at avoiding other unreasonable exclusions from plan participation, including exclusions based on salary, periods of service and terms of employment, (e.g., by distinguishing between part-time and full-time employees or those employed on an at-will and fixed-term basis). Regulation of voluntary and supplementary pension plans also aims towards similarly broad access, although the extent of such access may take into account factors including the voluntary nature of the arrangement, the unique needs of the employer establishing the pension plan, and the adequacy of other pension benefits.

- 5.2 Employees are equally treated under the plan rules with respect to portability rights, disclosure requirements, governance and redress mechanisms, and other rights associated with the plan.
- 5.3 If establishing rules for benefit levels and accrual or contribution rates, regulators may take into account the extent of integration of occupational plans with other public or mandated sources of retirement income and the adequacy of the totality of the benefits provided.
- 5.4 Employees are protected from retaliatory actions and threats of retaliation by their employer or pension plan representatives with respect to pension benefits and the exercising of rights under a pension plan. For example, they

should be protected from terminations of employment carried out with the intent to prevent the vesting of an accrued benefit under the pension plan. Similarly, individuals exercising their rights under a pension plan, including but not limited to their filing of a claim or appeal or their initiation of administrative or judicial action, should be protected from retaliatory action, such as termination of employment, suspension, discipline, fine or any other type of discrimination.

Benefit Accrual and Vesting Rights

- 5.5 Regulations promote the protection of benefits that an employee accrues by participating in an occupational pension plan, prevent the retroactive reduction of the value of benefits previously accrued in the plan and provide that plan members obtain timely notice regarding any reduction in the rate of future benefit accruals in the pension plan.
- 5.6 Accrued benefits vest immediately or after a period of employment with the employer sponsoring the plan that is reasonable in light of average employee tenure. Benefits derived from member contributions to the pension plan should be immediately vested.
- 5.7 Practices that substantially undermine or eviscerate benefit accrual and vesting rights are not permitted.
- 5.8 Vested benefits of those individuals who have severed employment with an employer are protected and not subject to forfeiture, regardless of reasons for severance, except in the limited case of dismissals resulting from acts of gross malfeasance that are clearly defined.
- 5.9 Vested benefits are protected from the creditors of the plan sponsor and plan service providers (including any financial institutions or other

entities managing the pension plan or plan assets or acting as a custodian of pension fund assets associated with the plan) – at a minimum by the legal separation of plan assets. Vested benefits are also protected when the plan sponsor or a plan service provider changes ownership due to merger, acquisition, sale, or other corporate transaction, or files for bankruptcy. Similarly, the extent to which vested benefits are protected from the creditors of individual plan members and beneficiaries is addressed.

Pension portability and rights of early leavers

- 5.10 Individuals who are changing jobs are able, upon request, to move the value of their vested account balance in a defined contribution plan from their former employer's pension plan either to the plan of their current employer (where permitted) or to a similar, tax-protected environment provided by an alternative financial instrument or institution. Where feasible, a similar portability right is available to individuals in defined benefit plans. There may be diminished need for individual portability rights where there are industry-wide and other types of multiple-employer pension plans.
- 5.11 Individuals have the right to timely execution of the request to transfer the value of their vested benefit accruals.
- 5.12 With respect to defined benefit pension plan benefits, the actuarial and interest rate assumptions used in valuing an individual's vested benefit accrual that is to be transferred are fair and reasonable. These assumptions are made readily available to the individual transferring the value of his vested benefit.

- 5.13 Portability rights are available to members of a pension plan when they separate from service with an employer, regardless of whether the separation is voluntarily, involuntarily or by mutual agreement.
- 5.14 Portability rights are not inhibited by the assessment of unreasonable charges or fees, such as excessive transaction charges or excessive back-end fees. At a minimum, members and beneficiaries are informed of the presence of any such charges or fees.
- 5.15 Individuals are not required to exercise their portability rights and, generally, are permitted to leave their vested benefits in the pension plan of their former employer.
- Disclosure and availability of information**
- 5.16 Members and beneficiaries in pension plans, as well as potential plan members, have a legal right to ready access or disclosure to basic information about the pension plan, including adequate information regarding their rights of access, anticipated contribution and/or benefit accrual rates, vesting schedules, other rights and obligations, investment policy, the names and manner of contacting responsible parties for plan administration and governance, and claims processes or procedures.
- 5.17 Plan documents, annual accounts, and annual financial and actuarial reports, if not automatically disclosed, are made readily available to plan members and to beneficiaries where relevant for copying for no more than reasonable charge or fee.
- 5.18 Members and beneficiaries are notified in timely fashion if required employer and member contributions have not been made to the pension plan.
- 5.19 Timely, individualised benefit statement is provided to each plan member (and to beneficiaries where relevant). The information included on the benefit statement and the frequency of its delivery will depend on the type of pension plan. The information included enables the plan member to identify current benefit accruals or account balances and the extent to which the accruals or account balances are vested. For pension plans with individual accounts, the information includes the date and value of contributions made to the account, investment performance, earnings and/or losses. For member-directed accounts, a record of all transactions (purchases and sales) occurring in the member's account during the relevant reporting period is provided. This information and other similarly personal data is maintained and delivered in a manner that takes full account of its confidential nature.
- 5.20 Individuals are provided adequate information about the rules associated with the portability of their vested benefit accruals, especially where the transfer of these assets may entail a loss of certain benefits or rights that were associated with the pension plan in which the benefit originated.
- 5.21 Disclosure materials are written in a manner expected to be readily understood by the members and beneficiaries to whom they are directed.
- 5.22 Consideration is given to adequate forms of delivery of disclosure materials, including mail, delivery at the workplace, and via email or websites, where feasible.
- 5.23 Amendments or changes to the pension plan that will significantly impact members and beneficiaries, their rights and their benefits

are disclosed to them in timely fashion and in a manner expected to be readily understood by them.

Additional rights in the case of member-directed, occupational plans

- 5.24 Where members direct their own investments in an occupational pension plan, they have the right to a number and diversity of investment choices sufficient to permit them to construct an appropriate investment portfolio in light of their own individual circumstances and in the context of the particular pension programme.
- 5.25 Members are provided with complete information regarding investment choices that is standardised and readily comparable. At a minimum this information should include disclosure of all charges, fees and expenses associated with each investment choice, as well as portfolio composition and historical investment performance data.
- 5.26 Members managing their own individual accounts have the right to timely and fair execution of their investment decisions and to written confirmation of these transactions. The right (or responsibility) to make and execute investment decisions should not be inhibited by the assessment of any unreasonable charges or fees.
- 5.27 Members and beneficiaries who are required to manage their own individual accounts are provided sufficient opportunity to acquire the financial skills or education and other assistance that they need in order to make appropriate investment decisions in their pension plans.

Entitlement process and rights of redress

- 5.28 Members and beneficiaries (and individuals claiming the right to be deemed a member or beneficiary under a pension plan) are entitled to a fair process or procedure in which their entitlements, rights and benefits under the pension plan may be claimed or asserted.
- 5.29 The claim process or procedure is expeditious and transparent. It is easy to understand and has only reasonable or no cost to the individual claimant.
- 5.30 The process includes independent administrative or judicial recourse if initial claims of rights or benefits are denied by the pension plan administrator, fiduciary, or employer. This process provides for adequate remedial measures to redress the loss of rights or benefits suffered by the member or beneficiary whose claim has been found to be valid.

Core Principle 6: Supervision

Effective supervision of pension funds and plans must be set-up and focus on legal compliance, financial control, actuarial examination and supervision of managers. Appropriate supervisory bodies, properly staffed and funded, should be established in order to conduct, when relevant, off and on site supervision, at least for some categories of funds and in particular when problems are reported. Supervisory bodies should be endowed with appropriate regulatory and supervisory powers over individual plans, in order to prevent miss-selling cases arising from irregularities in the distribution and expenses methods.

Organisation

- 6.1 Legal provisions clearly and objectively state the responsibilities of the pension supervisor.

- 6.2 These legal provisions grant the pension supervisor operational independence from both political authorities and commercial interference in the exercise of its functions and powers.
- 6.3 The legal provisions grant the pension supervisor adequate powers, legal protection, and proper resources and staff, and the capacity to perform its functions and exercise its powers.
- 6.4 The legal provisions require that the pension supervisor adopts clear, transparent, and consistent regulatory and supervisory processes. Where appropriate, the rules and procedures of the supervisor are published and updated regularly. These legal provisions allow the pension supervisor to consult, where appropriate, with the pensions sector when determining its approach to supervision and regulation.
- 6.5 The legal provisions require that the staff of the pension supervisor observe the highest professional standards including appropriate standards of confidentiality.
- 6.6 If its own capacities are insufficient, the legal provisions allow for the pension supervisor to outsource to third parties (e.g. auditors, actuaries) supervisory tasks such as on-site inspections and off-site monitoring.
- 6.7 Third parties are subject to the same confidentiality requirements as the pension supervisor and have legal liability for the services rendered. If required, the pension supervisor must have the ability to take actions against these third parties either directly or through the appropriate professional body.
- 6.8 The pension supervisor is empowered to exchange information with other relevant agencies, taking into account data protection standards.

Authorisation

- 6.9 The pension supervisor has the authority to inspect and, where necessary, require the revision of the founding documents of pension plans, pension entities, and pension fund managing companies.
- 6.10 The pension supervisor has the authority to execute a fit-and-proper test of the members of the governing body of pension funds in order to assess whether the person is qualified for the task. The supervisor has the authority to disqualify members of the governing body on the basis of this test.
- 6.11 The pension supervisor has the authority to reject a proposed member of the governing body on the basis of a fit and proper test.

Reporting / off-site supervision

- 6.12 The pension supervisor has authority to review and, where necessary, require the revision of the funding evaluation of defined benefit plans and the audited financial statement of pension funds that must be prepared on a periodic basis. The nature of this requirement should take into account information already required by other financial regulators.
- 6.13 The pension supervisor has the authority to review and, if it does not comply with current legal provisions, require the revision of the investment policy as set forth by the governing body of the pension fund.
- 6.14 The supervisor has the authority to review from time to time the actual investment strategies of pension funds and assess the extent to which their investment policies have been implemented.

On-site inspection

- 6.15 The pension supervisor has the authority to

undertake on-site inspections of a pension plan and fund, which include at least the activities listed below:

- evaluation of the governance and internal control system, including internal audit, reporting and monitoring;
- compliance with the contribution and benefit schedules as stated in the legal provisions and the pension plan’s charter;
- compliance with funding and investment regulations, including the plan’s investment policy and any relevant plan rules;
- analysis of the pension fund operations and relationships with external service providers and other parties (e.g. pension consultants, asset managers, and custodians).

6.16 If its own capacities are insufficient, the pension supervisor has the authority to delegate on-site examinations to external auditors, or other qualified parties. It must have sufficient powers to investigate and gather information deemed necessary to carry out its supervisory function.

6.17 The pension supervisor has the authority to carry out limited inspections, investigating only areas of specific concern.

Sanctions, intervention, and other remedial actions

6.18 The pension supervisor should be provided with comprehensive investigative and enforcement powers including:

- regulatory and investigative powers to obtain data, information, documents statements and records from persons involved in the relevant

conduct or who may have information relevant to the inquiry;

- power to seek orders and/or to take other action to ensure compliance with these regulatory,
- administrative and investigation powers;
- power to impose administrative sanctions and / or to seek orders from courts or tribunals;
- power to initiate or to refer matters for criminal prosecution.

6.19 There are procedures in place for the governing body of pension plans and pension funds to appeal to the pension supervisor for decisions taken by the latter that affect them and which they consider inconsistent with the legal provisions.

6.20 The pension supervisor has the authority:

- to require a change in the organisational or governance structure of a pension entity if it is deemed necessary to ensure their proper functioning.
- to request the replacement of members of the governing body that are not carrying out their duties in accordance with the legal provisions.
- in the case of external service providers, as appropriate, to request their replacement or report them to their own professional body.

6.21 The pension supervisor has the authority to intervene in the management of a pension plan on the basis of supervisory analysis that shows the likely insolvency of the plan.

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CHAPTER TWO - SITUATION ANALYSIS



2.1. INTRODUCTION

2.1.1 Focus of this Report

This chapter looks specifically at the current retirement arrangements in South Africa.

The purpose of this chapter is to identify where the existing framework fails to meet the needs of the country. From this base specific reforms will be proposed on the way forward (**Chapter 3**). This assessment occurs within the context of a reform process of the South African retirement system. Although the chapter does assess the state old age pension (SOAP), the focus is strategic, with the contributory system (a system in which people save for eventualities of little or no income) evaluated in more depth.

2.1.2 Background

The South African system of retirement has followed a fairly unique path compared to countries at the same and higher levels of development. While most other countries have had a clear policy framework in line with the objectives of a social security system, South Africa's system has grown out of a fully privatised system based on occupational and individual forms of cover. This has been supplemented by a safety net, in the form of a means-tested, flat-rate benefit for people likely to be unable to save effectively during their working life (the state old age pension or SOAP).

South Africa had an old age pension even during the period of apartheid. It was however differentiated by race. Whites received the highest payment and Africans the least, and Asians and Coloureds were somewhere in between¹. The first non-contributory pension scheme (a scheme in which the employer contributes, and not the employee) was introduced in 1928. It was designed for poor Whites and Coloureds, who were eligible over

the age of 65 (for males) and 60 (for females). The Pension Funds Act of 1928 was carried into effect according to the recommendations of the 1926 Pienaar Commission (Hendricks, 2004, p.3). By 1968 the disparity in pensions peaked at R31 for Africans, and R322 for urban Whites (Hendricks, 2004, p.5). However, significant steps were taken from 1990 onwards to fully equalise the grants, with equal benefits achieved just before 1994 (Hendricks, 2004, p.6).

The contributory system (where the employee pays a portion of the contribution), which provides benefits dependent on their earnings, has evolved primarily through occupational arrangements that were mainly defined benefit in nature. A DB arrangement involves a promise of specified benefits, calculated according to a formula, in exchange for contributions based on the same formula. These arrangements are supplemented, and/or substituted through private products, such as private annuities. A shift was made from DB to defined contribution (DC) arrangements, in which benefits depend on the value of contributions and interest, and from which administration and other costs are deducted. Private annuities are good examples of DC systems.

African workers were brought into the contributory pension system in the early 1980s. This was initially centered on objections to proposed legislation (Preservation of Pension Interests Bill of 1981), which would have required the compulsory preservation of pensions upon withdrawal from a fund for African workers. The objections were sufficiently strong for the legislation to be withdrawn. However, from that period on Black trades unions (in particular COSATU) developed their own provident funds and managed the investments. These funds are DC in nature and largely pay out lump-sum benefits.

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The absence of a compulsory tier of the South African contributory system makes it unique from an international perspective. In the same way, the absence of any form of state provision (or delivery) of an earnings-related retirement system is unusual. Consequently, South Africa is facing the challenge of reforming its retirement system from one that is unlike most developed and developing countries. These countries have gone the route of introducing different levels of private involvement and funding. South Africa, on the other hand, has to find ways of introducing structural changes to the retirement system through government intervention.

2.2. RETIREMENT ARRANGEMENT IN SOUTH AFRICA

2.2.1 Overview

This section classifies the types of private retirement arrangements found in South Africa, and looks at some of their statistical information (this information is mainly contextual and provides a reference for later sections of the report).

2.2.2 Types of retirement arrangement

Retirement funds can take a number of forms in South Africa:

- **Pension funds:** “These are funds established for the purpose of providing annuities (normally in the form of monthly pensions) for employees on their retirement from employment. In terms of Income Tax legislation, not more than one-third of the annuity payable may be commuted in a lump sum – accordingly, at least two-thirds of the benefit must be paid as a pension for the rest of the pensioner’s life.” (Olivier at al, 1999, pp.61-62).
- **Provident funds:** “These are funds established solely for the purpose of providing benefits for employees on retirement or solely for the purpose of providing benefits to a deceased member’s dependants or for a combination of both. The benefits may be paid by way of a lump sum. No employee contribution is tax deductible.” (Olivier at al, 1999, p.62).
- **Umbrella funds:** These are either pension or provident funds that a group of employers can join. These multiple-employer funds are typically sponsored by a financial services company. Essentially employees working for different employers or organisations are able to join a single fund. Umbrella funds operate on a DC basis, and as a result, are fully funded. These funds have no elected trustees — trustees usually drawn from the administration company (or its owner).
- **Segregated funds:** An arrangement in terms of which the investments of a particular pension scheme are managed by an insurance company, independently of other funds under its control. In such instances the managing structure of the pension fund meets the requirements of a single-employer pension fund, which is not the case with ‘umbrella funds’.
- **Retirement annuity:** This is a personal pension arrangement that can be taken out by an individual with a life assurance company. Contributions can be made as either a lump sum or monthly premiums. The monies placed in the fund are not accessible until the member is 55 years of age or older. The performance of the fund is usually linked to the market. These kinds of funds are registered with the Financial Services Board and the South African Revenue Service. Specific arrangements include ‘linked funds’, where annuities are tied to specified

investment types, such as unit trusts. Monies cannot be withdrawn before the principal reaches the age of 55, except in the case of disability pay-outs.

- **Preservation funds:** Persons who accept positions with new employers, and who cannot transfer their pension to a new fund, can use a preservation fund. A preservation fund allows an individual to 'park' their retirement savings somewhere until they can place it in a more appropriate fund. No tax is paid on withdrawal from the original fund, as the preservation fund has a similar (but different) tax status to ordinary pension funds and retirement annuities. It is possible to make one withdrawal of any amount from these funds before retirement age, but no top-up contributions can be paid. The rules of the previous employer's fund determine the rules applicable in the preservation fund.

The DC or DB status of a retirement fund is not affected by whether it is a pension or provident fund.

2.2.3 Funds supervised under Pension Funds Act

The Registrar of Pension Funds identifies the following three categories of fund supervised in terms of the Act (Registrar of Pension Funds, 2003):

- **Foreign funds:** funds whose headoffices (or the head offices of participating employers) are located outside the Republic of South Africa
- **Underwritten funds:** funds that operate exclusively by means of issued by registered insurers
- **Self-administered funds:** funds that invest their own assets.

2.2.4 Funds not supervised under the Pension Funds Act

A number of funds have been established through special laws and include the pension fund for public servants and various parastatals.

- **Official funds:** "These funds are supervised by National Treasury under the relevant laws ... There are currently four official funds in existence namely: Temporary Employees Pension Fund, Associated Institutions Pension Fund, Associated Institutions Provident Fund and Government Employees Pension Fund."
- **Transnet Fund:** "A fund for the employees of Transnet was established by the Transnet Pension Fund Act, 62 of 1990, with effect from 29 June 1990 ..."
- **Telkom Fund:** "A fund for the employees of Telkom SA Limited was established in terms of section 9(1) of the Post Office Act, 1958 (Act No.44 of 1958), with effect from 1 October 1991 ... Another fund, the Telkom Retirement Fund, is supervised under the Act."
- **Post Office Fund:** "The Post Office Pension Fund, that was established in terms of section 10 of the aforementioned Act, with effect from 1 October 1991 ..."
- **Bargaining Council Funds:** "Funds that have been established by collective agreements concluded by councils in terms of the Labour Relations Act, 66 of 1995 and have opted not to register under the Pension Funds Act. The Department of Labour supervises these funds, which are exempted in terms of section 2(1) of the Act from the provisions of the Act other than the requirement to furnish certain statistical information ..."

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2.2.5 Fund Types: a review

The total membership of retirement funds, including pensioners, has varied from 9,8 million in 2002 to 9 million in 2003 and back up to 9,85 million in 2004. Some of this variation seems to be due to reporting problems each year, with a fairly large number of funds not reporting to the Registrar. In 2004 for instance, statistical information was provided only

in respect of 2 360 (or 69,3%) self-administered funds, out of a total of 3 407 funds (Registrar of Pension Funds, 2005 reports 44-46).

In 2004 there were 8.7 million active members and 1.1 million pensioners, deferred pensioners and dependants. However, the membership data includes a double count as some belong to more than one fund (Registrar of Pension Funds, 2005).

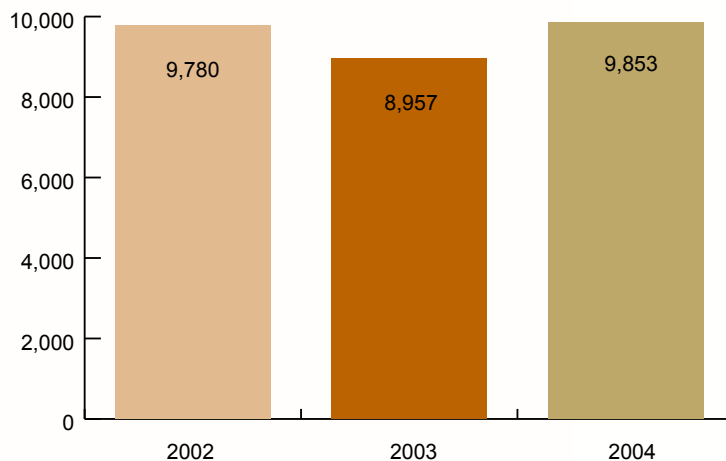


Figure 2: Membership of Pension Fund arrangements for the period 2002-4

Source: Registrar of Pension Funds, Annual Reports 2004, 44-46
(These figures do not represent the total number of actual members as some people belong to more than one fund)

Overall the membership of underwritten funds (funds backed by financial institutions) is more than that of self-administered funds (funds that are not-for-profit). However, there has been a declining trend for underwritten funds as a proportion of total funds from 2002 to 2004, with a movement (from 56,4% of all members to 47,6% over three years). Self-administered funds have increased their proportion from 26,6% to 36,2% over the same period.

Although underwritten funds have the most members, their assets are much less than those of self-administered funds and official funds. The declining trend in underwritten funds is also reflected in the proportion of assets, reducing from 22,6% in 2002 to 20,7% in 2004. It is interesting to note that self-administered funds, which have only 36,2% of all members (2004's figure), have 42,5% of all assets. Official funds, with only 13,7% of all members (2004's figure) have 32,3% of all assets.

It seems therefore that occupational funds (including official funds) are the primary choice as a retirement fund for most people. It also seems that the highest income groups tend to make use of occupational retirement funds. Underwritten funds are seemingly used by the self-employed as a primary retirement

vehicle, and as a secondary retirement vehicle for the formally employed.

The total value of assets in retirement funds in 2004 reached a trillion rand for the first time, showing an increase of 22.8% from 2003.

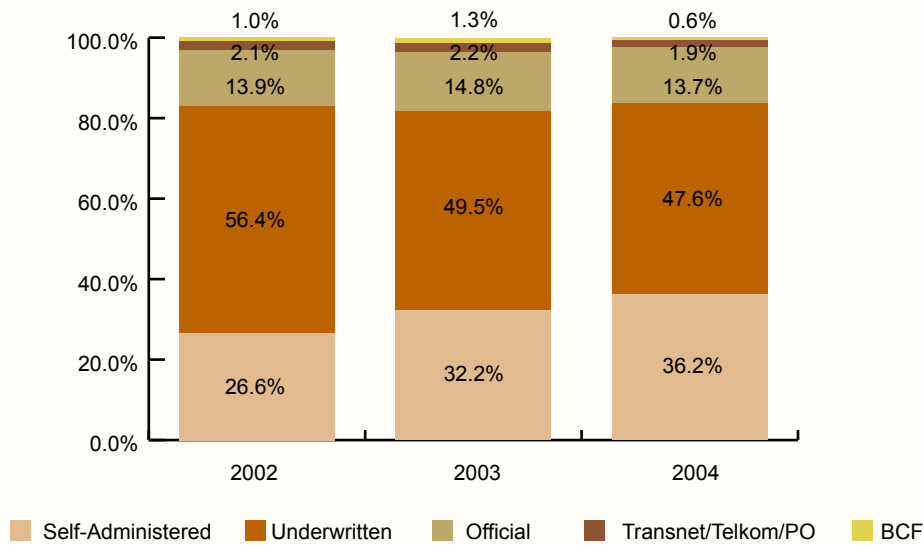


Figure 3: Membership of Retirement Funds: 2002-4 (Percent of Total)

Source: Registrar of Pension Funds, Annual Reports 2004, 44-46

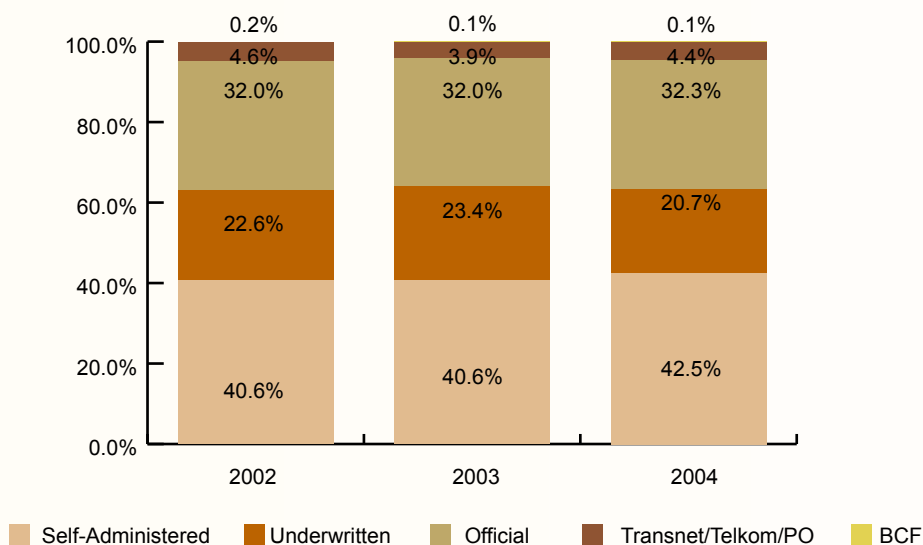


Figure 4: Aggregate Assets of All Funds: 2002-4 (Percentage of Total)

Source: Registrar of Pension Funds, Annual Reports 2004, 44-46

2.3. PENSION COVERAGE IN SOUTH AFRICA

2.3.1 Introduction

In order to understand the issue of pension coverage in South Africa, one needs to distinguish between non-contributory flat-rate (i.e. the SOAP) and contributory earnings-related environments. The non-contributory system is means-tested and targets those with virtually no income in retirement. The contributory system in South Africa is a voluntary earnings-related environment with various fund types as alternatives, depending on the individual circumstances of contributors.

Whereas the SOAP is seen as a critical poverty alleviation mechanism, with many socio-economic benefits, the contributory system has proven more difficult to evaluate. Although coverage appears relatively good, the quality of the coverage has never been properly assessed. It would therefore be unwise, when reviewing the data, to reach a definitive conclusion that coverage is good.

This section attempts to build an accurate picture of coverage and the quality of coverage. It also tries to identify those people who could potentially participate, but are excluded from the environment, or who participate and are unfairly treated.

The analysis shows that while low-income groups have access to reasonable protection from poverty, those who cannot benefit from the SOAP are worst off. This includes the informal sector and the self-employed. High-income formally employed people, on the other hand, benefit from tax subsidies and access to low administration charges.

2.3.2 Coverage

As at December 2004 the Registrar of Pension Funds supervised 13 618 registered pension funds

(down slightly from 13 766 in 2003), including the Government Employees Pension Fund (GEPF), as well as those of Transnet, Telkom and some bargaining councils (Registrar of Pension Funds, 2004).

At the end of 2004 the total membership of retirement funds was 9,9 million, of which 8,7 million were active members and 1,13 million were pensioners, deferred pensioners and dependants. As these figures include participation in more than one fund, they are an inaccurate reflection of total participation. (Registrar of Pension Funds, 2004).

The total assets of the retirement fund industry in South Africa in 2004 stood at R1 098 billion, with annual contributions of R72 921 billion and benefits of R86 150 billion paid out.

Despite the appearance of effective coverage, i.e. 8,7 million active members (including an unspecified number of people who are members of more than one retirement fund) versus 7 million people in formal employment (Stats SA, June 2005), no study has produced an accurate picture of the income profile of contributors and what portion of their incomes when working are represented by the final benefits (often referred to as the replacement rate). An indication of the scale of the gap in coverage can be shown when reference is made to the total employed population (rather than employees in the formal sector) which stands at 11,3 million (Stats SA, September 2005) which is considerably higher than the number of existing contributors.

Although it is clear that the retirement industry is quite successful commercially, it is less clear how effective it is from a social security perspective. **Tables 5 and 6** provide data and estimates of key aspects of the coverage environment for 2005.

The total number of contributors to retirement funds is estimated at 6 million, based on an estimate of

the double-count that exists in the reported information. The double count is estimated at 1,3 for every contributor (or 30%). The total number of employed people who don't contribute to a retirement fund is estimated at 5,4 million, and the total potential contributors are 11,3 million (this figure excludes agricultural and unspecified workers in the Labour Force Survey (LFS) (September 2005).

Based on these figures of the potential contributors to retirement funds in the age range 16-64, a large proportion (estimated at 47,8% or 5,4 million) does not participate. This suggests that coverage through private retirement vehicles is not that significant when all income earners are considered, rather than just the formally employed.

However, total employment here includes the informal sector which faces structural barriers to

accessing retirement arrangements. The informal sector is estimated at 2,5 million (LFS, September 2005). Domestic workers, another group likely to face structural barriers, are estimated at 859 000 (LFS, September 2005). If these are excluded from assessment, there are approximately 8 million formal sector workers, approximately 2 million more than the number of contributors. Crude coverage of the formal sector, assuming no informal sector or domestic workers contribute, is therefore 73%.

If these estimates are a valid indication of potential contributors, roughly 575 005 retirees could have private retirement provision instead of relying on the SOAP. If females in the age range 60-64 are included (because the SOAP begins at 60 for females) this figure rises to 842 463. This is roughly equivalent to the total estimated number of beneficiaries of private retirement arrangements in 2005.

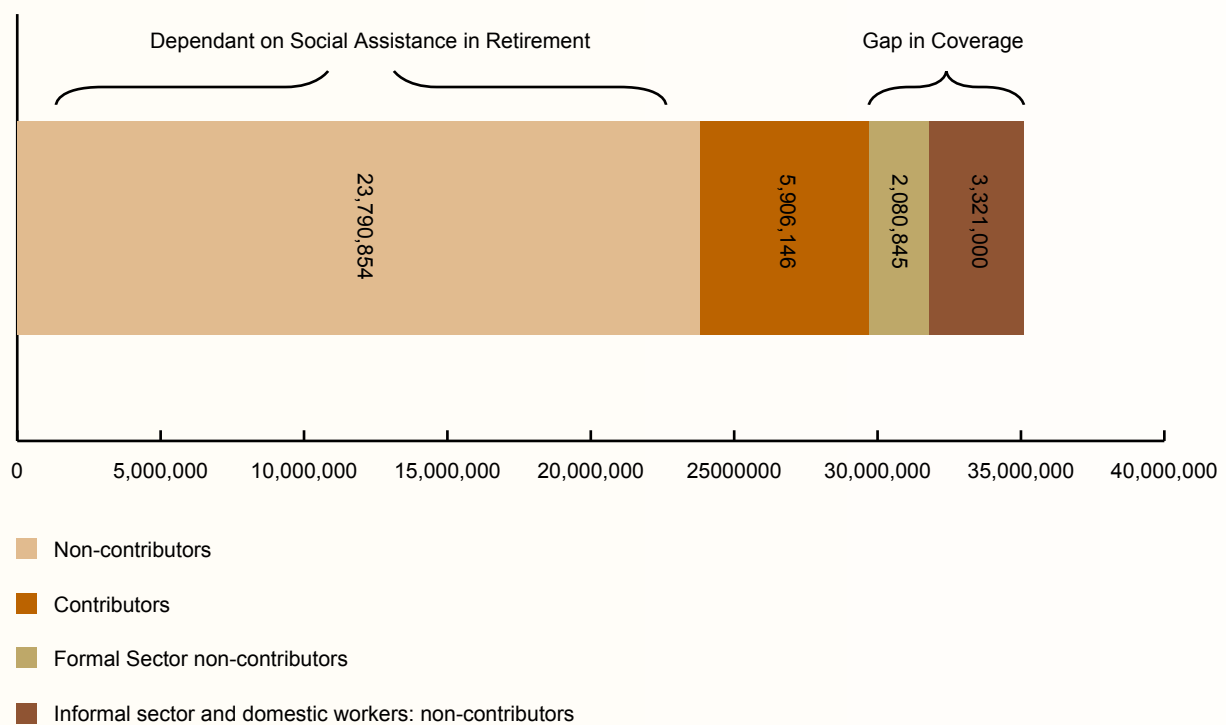


Figure 5: South African Retirement System: Contributors, Non-contributors, and Potential Contributors (estimate for 2005)

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Table 5: Working age population, employment status, and form of retirement coverage, estimates for 2005

| Population segment | Non-contributors | | | | Contrib. | Contrib. & Non-contrib | Pot. Contr. |
|--------------------|------------------|------------------|--------------|------------|-----------|------------------------|-------------|
| | Employed | % of pot. Contr. | Not-employed | Total | | | |
| 16-64 | 5,401,854 | 47.8% | 18,389,000 | 23,790,854 | 5,906,146 | 29,697,000 | 11,308,000 |
| 65+ | 575,005 | 39.3% | 862,622 | 1,437,627 | 889,573* | 2,327,200 | 1,464,578 |
| Females 60-64* | 267,458 | n/a | 401,242 | 668,700 | n/a | n/a | n/a |
| Total | 5,976,858 | n/a | 19,251,622 | 25,897,181 | 6,795,719 | 32,024,200 | 12,772,578 |
| Retirees total | 842,463 | n/a | 1,263,864 | 2,106,327 | | | |
| Recipients of SOAP | | | | 2,106,327 | | | |
| 65+ total | | | | 1,437,627 | | | |
| Females 60-64* | | | | 668,700 | | | |

Source: Data based on estimates summarised in table 6 below

*This figure also assumes a double-count in retired recipients of benefits and is based on the number of people over 65. The figure is not meant to include beneficiaries below the age of 65 (including widows and orphans). This is purely a simplification for convenience.

Table 6: Vital statistics of the South African retirement system

| | Data | Source |
|--|------------|---|
| Working age (15-64) | 29,697,000 | LFS, Sept 2005 |
| Employed (15-64) | 11,308,000 | LFS, Sept 2005 (excl. agric and unspc.) |
| Formal employment | 7,987,000 | LFS, Sept 2005 |
| Ret. fund contributors | 8,268,605 | FSB, ave. taken for 2003 and 2004 |
| Social assistance beneficiaries | 2,106,327 | DoSD, Aug 2005 |
| Ret. fund beneficiaries | 1,140,193 | FSB, result for 2003 (close to 2004) |
| Over age 65: total | 2,327,200 | Stats SA, m/y pop estimate, 2005 |
| Males over age 65 and females over age 60 | 2,995,900 | Stats SA, m/y pop estimate, 2005 |
| Over age 65: total less social ass. ben. | 889,573 | estimate for 2005 |
| Estimated double-count on ret. fund ben. (ratio) | 1.4 | estimate for 2005 |
| Estimated actual ret. fund contributors | 5,906,146 | estimate for 2005 |
| Contributors: working and retired (adj. for d/c) | 6,795,719 | estimate for 2005 |
| Total working non-contributors | 5,401,854 | estimate for 2005 |
| Total retired "working" non-contributors | 575,005 | assumption for 2005 (9% of segment) |

2.4 QUALITY OF COVERAGE

2.4.1 Overview

Coverage is only one indicator of the adequacy of the private retirement system. A more important

issue is the quality of the coverage. There are many factors that could contribute to a reduction in the value of benefits, such as early withdrawals, switching into expensive private annuity products, high administration costs, lumpiness of investment

performance, fund failures and gaps in lifetime contributions. None of these factors have been properly analysed to date in South Africa. Further difficulty is caused by the poor quality of data generated by the Registrar of Pension Funds, which cannot be easily used to assess the quality of coverage.

The unknown factors indicated above influence the final replacement value achieved, seen against its cost ratio. There is currently no measure in South Africa for either of these outcomes.

Given the difficulties with respect to the accuracy of data, proxy indicators (assumed figures) are needed to give some indication of retirement fund performance. However, it should be noted that the factors influencing retirement fund performance change all the time. An assessment of the proxy indicators should, where possible, provide an understanding of trends.

The approach in this section, given this context, is to evaluate a number of issues that could affect the quality of coverage. Based on this evaluation, broader conclusions can be drawn.

2.4.2 Assessment of Variations from Full Participation

According to the Registrar of Pension Funds (2004), Exempt Funds have the most members — 4,7 million or 47,6% of all funds. Self-administered funds are the next most important with 3,6 million members or 36,2% of all funds. Exempt and Self administered Funds together, therefore, account for 83,7% of all reported members. Official funds have 1,4 million members, accounting for 13,7% of all members. Including Official with Exempt and Self-administered Funds accounts, 97.5% of all members can therefore be accounted for.

Table 7: Membership by Pension Fund Type (2004)

| Fund types | Funds | Members per fund | Members | | | Pens. (% of tot) |
|--------------------------|---------------|------------------|------------------|------------------|------------------|------------------|
| | | | Total | Active | Pensioners | |
| Self-administered funds | 3,407 | 1,046 | 3,562,860 | 3,167,500 | 395,360 | 11.1% |
| Exempt funds | 10,196 | 460 | 4,685,644 | 4,335,281 | 350,363 | 7.5% |
| Official funds | 4 | 338,320 | 1,353,279 | 1,063,000 | 290,279 | 21.5% |
| Transnet funds | 3 | 54,876 | 164,627 | 74,005 | 90,622 | 55.0% |
| Telkom Pension Fund | 1 | 342 | 342 | 342 | 0 | 0.0% |
| Post Office Pension Fund | 1 | 23,660 | 23,660 | 17,237 | 6,423 | 27.1% |
| Bargaining Council funds | 4 | 15,654 | 62,616 | 62,616 | 0 | 0.0% |
| Total | 13,616 | 724 | 9,853,028 | 8,719,981 | 1,133,047 | 11.5% |

Source: Registrar of Pension Funds, 2004.

The pensioner ratio (the number of pensioners compared to the number of working contributors) in Exempt Funds is 7,5%, which is much lower than Self-administered Funds (11,1%) and Official Funds

(21,5%). The difference between Self-administered Funds and Official Funds is also significant. The Transnet Fund shows a remarkable pensioner ratio of 55%.

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If it is assumed that pension contributions should roughly begin at age 25 and continue to retirement at age 65 (i.e. 40 years of contribution), based on the high-income population in South Africa, a pensioner ratio of 9,1% is expected, or normal. Variations from this would show distortions resulting from poor life-time participation, young average ages of retirement, and changes in employment patterns.

Given that all South Africa's fund types vary significantly from the "normal" pensioner ratio, it has to be concluded that significant distortions exist in fund participation and employment practices. However, different explanations are likely the private, and public and semi-public sector funds.

The private sector funds may face two scenarios, both indicating problems with participation:

- **Participation grows with age:** The first, illustrated by the Self-administered Funds, is a potential low-level of initial participation by age with increased participation occurring as retirement age nears. **Figure 6** shows the relevant demographic curve relative to the general population for higher income groups, if 65 is taken as the age of retirement.
- **Participation declines with age:** The second scenario, illustrated by Exempt Funds, involves declining participation over time in relation to the numbers of the general population. Therefore, there are higher rates of participation in younger

age categories than in older age categories. This would explain the high annuity lapse rates seen in the market. (See **figure 6**).

The pensioner ratios of the official and semi-public sector funds (i.e. Transnet and Telkom) are equally problematic but for different reasons. They have excessively high pensioner ratios, which can be explained as follows:

- **Early retirement age:** The age of retirement is set low, or becomes low through the practice of permitting excessive early retirement. If this were the sole explanation for the pensioner ratios, the Official and Post Office Funds would have average retirement ages of around 50-55 years, while the Transnet Fund would have a retirement age equivalent to 35-40 years!
- **Reduction in the labour force:** Another explanation would be a reduction in the size of the labour force. This could be caused by a policy of staff reductions or through the sale and/or transfer of subsidiary entities, while retaining the pension liability in the original fund.

If the Exempt Funds are excluded, and only occupational funds (public and private sector) are counted, the pensioner ratio is 18,1%, which is double the expected ratio. If Exempt Funds are included, the ratio drops to 11,5%. However, this figure includes potentially low-quality coverage. Nevertheless, even the figure of 11,5% indicates a significant distortion from the expected ratio.

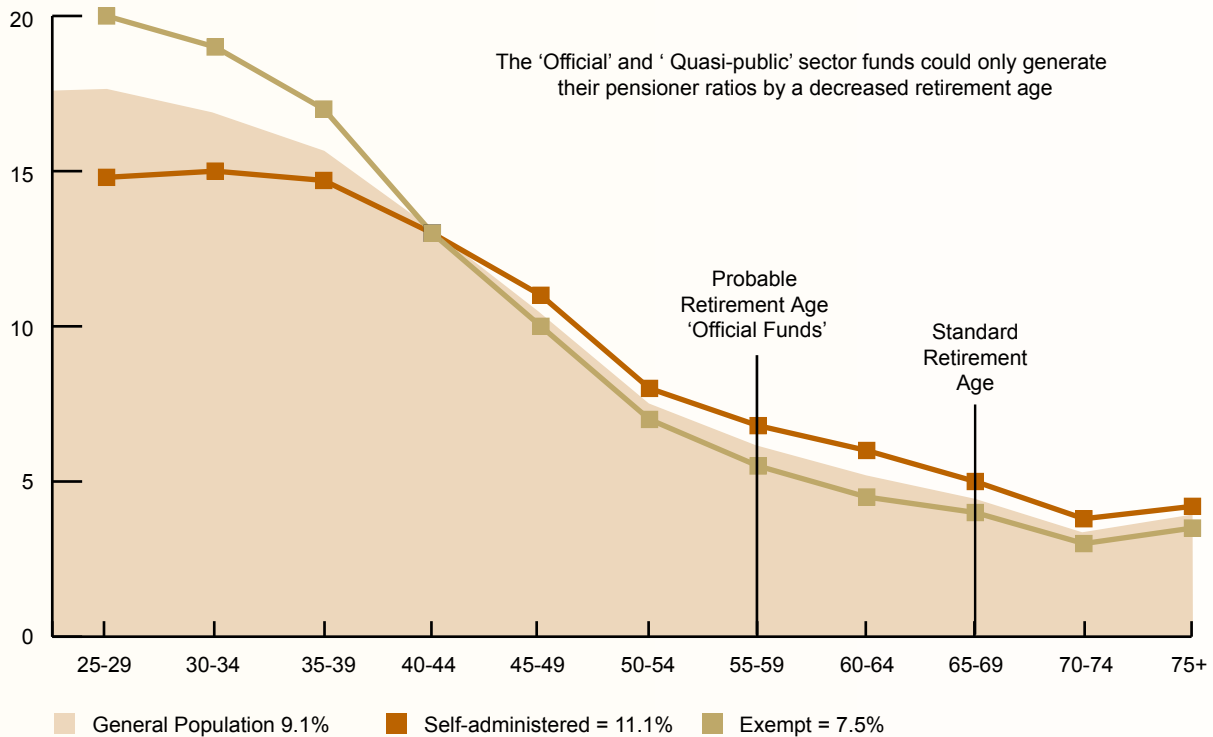


Figure 6: Possible demographics of the various fund types based on their pensioner ratios

The demographic distortions in participation noted here suggest that coverage is not complete across all relevant age ranges, with poor participation in the younger age groups. For people unable to access occupational arrangements, participation appears to drop off with age. These conclusions are applicable to retirement arrangements accounting for 83,7% of all members, i.e. all the full private sector funds. Retirement funds for the public and semi-public sector do not reflect poor coverage, which is likely to be very good due to its compulsory nature, but instead suggest distortions in how they have been, and are, managed.

2.4.3 Fund Revenue, Benefits and Assets

Although Exempt Funds have most members, revenue per member is less than half that of Self-

administered Funds (R7 060 compared to R14 693) and less than a third that of Official Funds (R26 679). This picture is also reflected in benefits paid, where Exempt Funds not only pay out below the average level of benefits, but most (60%) is in the form of lump-sum benefits. Exempt Fund assets per pensioner are also roughly half that of Self-administered and Official Funds.

The average value of benefits paid out by Self-administered Funds is greater than all other fund types. However, this should be qualified by the much greater pension relative to lump-sum payments provided by the Official and semi-government retirement funds. As lump-sum benefits tend to be once-off, pension benefits are a better reflection of the quality of benefits.

The ratio “assets per pensioner” provides a crude

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indicator of the level of funding underpinning the liabilities of each fund type. From this assessment the Transnet Funds appear low for its pensioner ratio. Ignoring this anomalous Fund, the picture of the remaining types is revealing.

Exempt Funds have the lowest level of assets per pensioner out of all fund types (excluding the Bargaining Council and Transnet Funds) and is around 50% of Self-administered and Official Funds. This reflects their low level of benefit relative to alternative fund types rather than any funding

deficit, which is unlikely.

Self-administered Funds have roughly the same value of assets per pensioner as Official Funds, and 33,1% more than the Post Office Pension Fund. Thus, the assets relative to revenues are greater in the Self-administered Funds relative to the Official and Post-Office Funds, suggesting that they are better funded. These conclusions should be treated with caution, as no attempt has been made here to evaluate the individual funds concerned.

Table 8: Average Benefits Paid by Fund Type (2004)

| Fund Types | Lump-sum Benefits | | Pension Benefits | | Total (Rands) |
|-------------------------|-------------------|--------------|------------------|--------------|---------------|
| | (Rands) | % of total | (Rands) | % of total | |
| Self-administered funds | 27,524 | 50.6% | 26,844 | 49.4% | 54,368 |
| Exempt funds | 19,129 | 59.9% | 12,792 | 40.1% | 31,921 |
| Official funds | 11,472 | 25.0% | 34,477 | 75.0% | 45,949 |
| Transnet funds | 18,561 | 40.6% | 27,179 | 59.4% | 45,740 |
| Post Office Fund | 10,120 | 25.2% | 30,048 | 74.8% | 40,168 |
| Overall | 20,072 | 45.0% | 24,499 | 55.0% | 44,571 |

Source: Based on the Registrar of Pension Funds (2004).

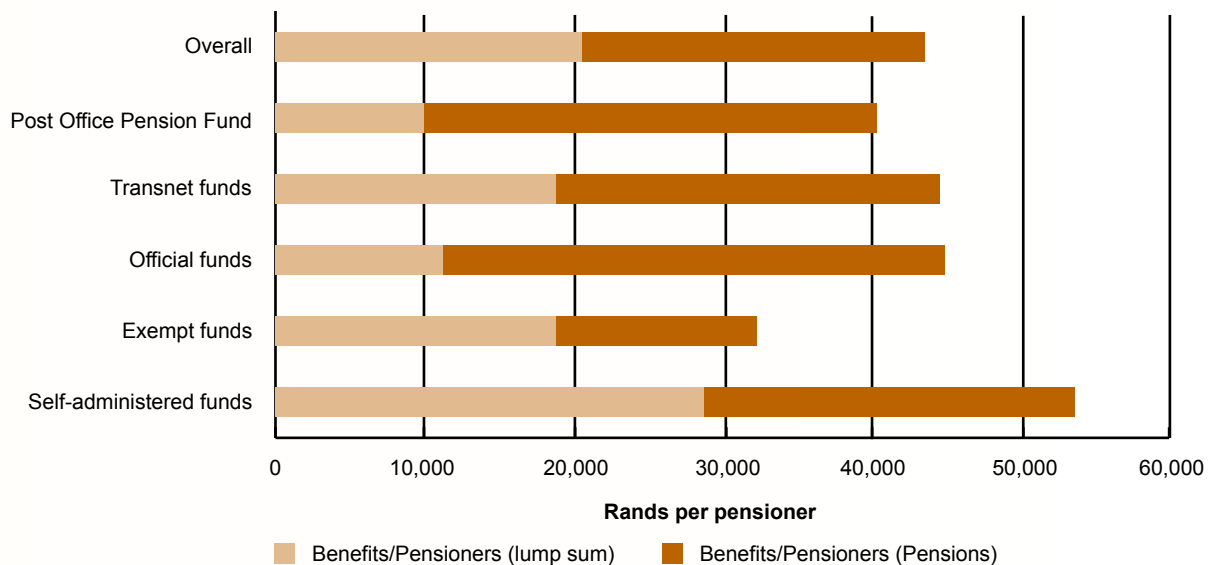


Figure 7: Ratio of Benefits per Pensioner, Pensions and Lump sum

Source: Based on Registrar of Pension Funds, 2004.

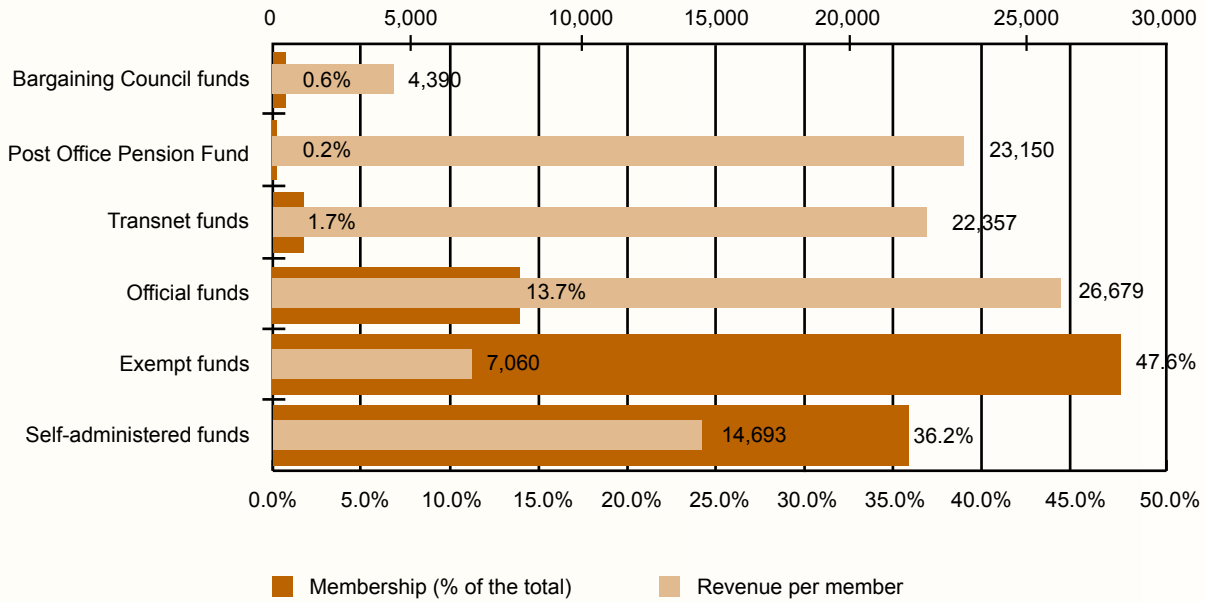


Figure 8: Membership by Pension Fund Type and Revenue Per Member by Pension Fund Type (2004)

Source: Based on Registrar of Pension Funds, 2004.

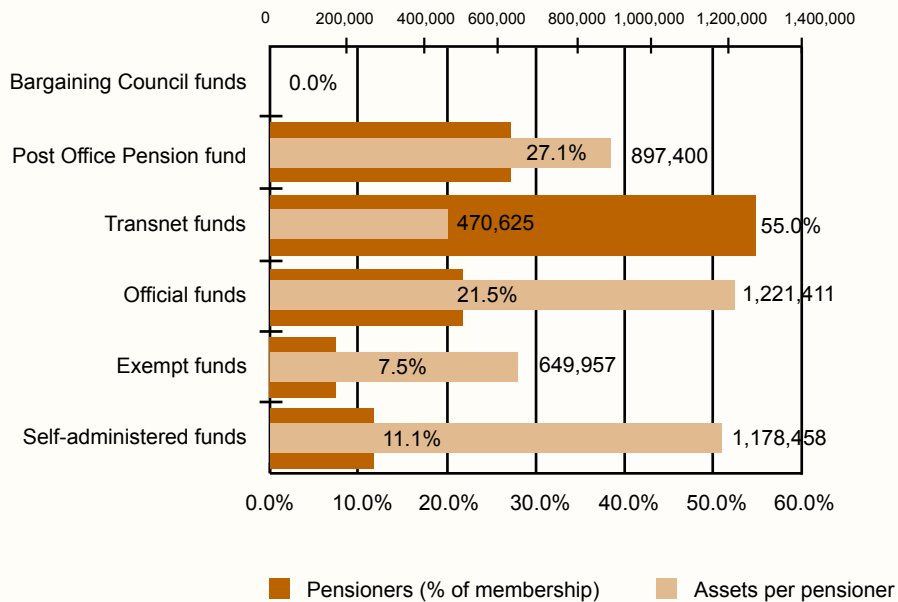


Figure 9: Pensioner Ratio and Assets per Pensioner (2004)

Source: Based on Registrar of Pension Funds 2004.

2.4.4 Estimated Replacement Rates

As explained before, replacement rates refer to the proportion of income “replaced” by retirement income from a pension fund.

Without going through the rules of each individual retirement fund and following up the behaviour and retirement outcome for each individual, it is not possible to accurately portray the replacement rates achieved by South African retirement funds. However, a crude assessment is performed here to provide some idea of the effectiveness of retirement provision for those participating in a retirement fund within South Africa. Two approaches are used:

An assumed final replacement rate by fund type is used and weighted by the membership participating in each. The estimate of dual membership is dealt with by distributing the double-count between Self-administered, Exempt and Official Funds according to the following percentages: 25%, 50% and 25% respectively. The reasons for the chosen replacement rates by fund type are:

- **Self-administered:** the replacement rate is assumed to be similar to that of official funds, using a sample of benefit calculations applicable to the Government Employees Pension Fund (GEPF). The same replacement rate is assumed for all funds except Exempt funds.
- **Exempt funds:** given that revenue and benefit payouts are 50% of Self-administered Funds, it is assumed that average replacement is half that of Self-administered Funds, i.e. 20%.
- **Double-count:** Where it is assumed that someone is a member of two funds, the standard replacement rate of both fund types is added. The dual membership is assumed to always involve an Exempt Fund.

The income distribution, as reflected in the 2001 Census (StatsSA) is shown for people of working age (16-64) and from age 65. The shift in the income structure between the two age categories is assumed to provide some reflection (although not conclusive) of the changed income levels in retirement. This change includes income from all sources and not merely from retirement funds. The weighted shift for the household income range above R3 201 (2001 prices) is used as a proxy for people likely to have private retirement arrangements.

For the population covered, a replacement rate of 42% emerges based on approach (1) indicated above. (**See table 9**). It is likely that this both over-estimates the true average, and hides a likely wide variation in replacement rates. Replacement rates are, inter alia, likely to vary for the following reasons:

- Movement in and out of employment;
- Irregular lifetime contributions;
- The value of defined contribution benefits depending upon whether benefits matured at the bottom or the top of an economic cycle; and
- Collapse of the fund.

Approach (2) suggests a weighted decline in income of 45,8% for people over the age of 65. This suggests a ‘replacement rate’ of 54.2% for households in the R3 201 income range and above. The household income ranges R401 – R1 600, however, show significant improvements in the post-retirement group, which is primarily related to the effect of the SOAP rather than private retirement.

Table 9: Estimated replacement rates for South African Funds based on 2004 reported data and assumptions

| Fund types | Reported | Exempt adjusted | | R-rate* | Weight |
|-------------------------------|------------------|------------------|---------------|--------------|------------------|
| Self-administered funds | 3,167,500 | 2,464,041 | | 40.0% | 985,617 |
| SA- dual | | 703,459 | 25.0% | 55.0% | 386,902 |
| Exempt funds | 4,335,281 | 114,529 | | 20.0% | 22,906 |
| Exempt -dual | | 1,406,917 | 50.0% | 35.0% | 492,421 |
| Official funds | 1,063,000 | 359,541 | | 40.0% | 143,817 |
| Official-dual | | 703,459 | 25.0% | 55.0% | 386,902 |
| Transnet funds | 74,005 | 74,005 | | 40.0% | 29,602 |
| Telkom Pension Fund | 342 | 342 | | 40.0% | 137 |
| Post Office Pension Fund | 17,237 | 17,237 | | 40.0% | 6,895 |
| Bargaining Council funds | 62,616 | 62,616 | | 40.0% | 25,046 |
| Total/weighted average | 8,719,981 | 5,906,146 | 100.0% | 42.0% | 2,480,244 |
| Estimated actual | 5,906,146 | | | | |
| Difference | 2,813,835 | | | | |

Table 10: Differences in income before and after retirement (based on the Census 2001 data) (2001 prices)

| Household Income ranges | Average Income (2001) | % of pop over 65 | % of pop from 20 to 64 | weighted shift | |
|--------------------------|-----------------------|------------------|------------------------|----------------|---------------|
| | | | | over 65 | from 20 to 64 |
| No income | 0 | 5.2% | 19.8% | 0 | 0 |
| R 1 - R 400 | 201 | 3.1% | 6.8% | 6 | 14 |
| R 401 - R 800 | 601 | 31.2% | 15.4% | 187 | 92 |
| R 801 - R 1,600 | 1,201 | 25.0% | 16.7% | 301 | 201 |
| R 1,601 - R 3,200 | 2,401 | 15.2% | 15.5% | 365 | 372 |
| R 3,201 - R 6,400 | 4,801 | 9.7% | 10.9% | 467 | 521 |
| R 6,401 - R 12,800 | 9,601 | 6.0% | 7.7% | 580 | 740 |
| R 12,801 - R 25,600 | 19,201 | 2.9% | 4.7% | 550 | 893 |
| R 25,601 - R 51,200 | 38,401 | 1.0% | 1.7% | 371 | 660 |
| R 51,201 or more | 100,601 | 0.7% | 0.9% | 721 | 946 |
| Total | | 100.0% | 100.0% | 3,548 | 4,440 |
| Weighted shift: total | | | | 25% | |
| Weights (R3,201+) | | | | 2,222 | 3,240 |
| Weighted shift (R3,201+) | | | | 45.8% | |
| Replacement (R3,201+) | | | | 54.2% | |

Source: Based on Stats SA, 2001 Census.

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The results from this assessment suggest that private retirement provision, although potentially adequate when aggregated, is not remarkable and likely to vary significantly. There is a distinct detectable drop in incomes as people go into retirement, roughly of the order of 50% or more. The income declines of low-income groups appear less severe because of the impact of social assistance. The total absence of any routine statistics monitoring replacement rates is troubling and would likely demonstrate serious gaps in coverage which are not detectable from a highly aggregated analysis such as the one provided in this section.

An alternative approach is to assess the cumulative replacement rate for groups currently participating in a retirement fund by using the cumulative contribution rate in a given year expressed as a percentage of the cumulative income of all contributors.

Using this approach the average contribution rate is 11,4% (see **table 7.1**). As is apparent from **section 2.6.6**, the differences in the starting income have little impact on cost ratios and replacement rates. Provided all other assumptions remain constant, it is possible to provide an industry replacement rate consistent with reported information. **Table 11** provides a breakdown of this scenario using the estimated average annual income of contributors of R90 707. The replacement rate is based on the value of an annuity capable of paying out for 25 years based on the value of the maturity value of accumulated assets at age 65.

The results suggest an industry replacement rate of 23,9% with an average cost ratio of 23,9%. This replacement rate is considerably lower than that arising from the previous two approaches.

Table 11: Estimate of the Industry Replacement Rate for Contributors based on 2005 participation and cost information.

| Table 11: Estimate of the Industry Replacement Rate for Contributors based on 2005 participation and cost information. | | |
|--|--|-----------------------------------|
| Assumptions | Income: start pre-tax | 90,707 |
| | Income increase (real % pa) | 0.0% |
| | Income increase (nominal % pa) | 5.0% |
| | Pension contribution (% of pre-tax income) | 11.1% |
| | Interest rate (real % pa) | 3.0% |
| | Interest rate (nominal % pa) | 8.0% |
| | Inflation | 5.0% |
| | Fee: Contribution (% of contribution) | 9.0% |
| | Other costs: (% of contribution) | 2.8% |
| | Expenses total: (% of contribution) | 11.8% |
| | Fee: Contribution (% of pre-tax income) | 0.0% |
| | Fee: % of assets | 0.6% |
| | Value of tax on interest earnings(%) | 9.0% |
| | Results | Income: Final (pre-tax) (nominal) |
| Income: Final (pre-tax) (yr1 prices) | | 90,707 |
| Accumulation: with charges (nominal) | | 1,985,364 |
| Accumulation: without charges (nominal) | | 2,608,845 |
| Accumulation: with charges (yr 1 prices) | | 296,113 |
| Cumulative expenses at retirement | | 623,480 |
| Retirement income (nominal) | | 147,595 |
| Retirement income (yr 1 prices) | | 22,014 |
| Charge ratio (incl. tax) | | 23.9% |
| Replacement rate (LE = 25yrs) | | 24.3% |

2.5. CONCLUDING REMARKS

The quality of the coverage provided by funds other than Exempt Funds, although unexceptional, appears adequate when assessed in combination. However, a large degree of variability is likely, based on the variation in pensioner ratios from the benchmark of 9,1%. These variations are probably due to delayed participation in retirement, early withdrawals, and the value of retirement benefits based on the time in the economic cycle in which benefits mature. There is evidence of at least a 45% drop in incomes during retirement (including all sources of income), with replacement rates of retirement vehicles at an estimated 42%. However, when current levels of contribution are assessed, the estimated aggregate replacement rate is 24,3%, which is nearly half this value.

2.6. ADMINISTRATION CHARGES

2.6.1 Overview

Remarkably a recent National Treasury discussion paper (December 2004) fails to even mention the issue of administrative expenses and charges in relation to retirement. This omission is troubling given its emphasis in virtually all World Bank assessments and international studies. One reason for this oversight may be that reliance is placed on the reported statistics of the Registrar of Pension Funds (2005) where a crude average of 13% is indicated as an aggregate for all reporting funds. However, use of such a figure to assess administrative expenses is not usual and such a measure is far from adequate. A recent review of retirement costs in South Africa by Rusconi (August 2004) revealed very high charges and low value for money within the private retirement market. Rusconi (2004, p.97) revealed that instead of 13%, cost ratios for most policies range between 26.7% and 43.2%.

Costs are important because they impact on the final value of any retirement payout. The poor coverage of this issue both by the regulator and National Treasury (the responsible department overseeing the Pension Fund regulator) is problematic and suggests strongly that the issue may have a lower priority than it should. This section therefore provides an assessment of administrative charges relevant to South Africa.

2.6.2 Forms of administration charge

The relevant measures in assessing charges are laid out in Chapter 1 (**section 5.2**) and are repeated here for convenience.

The fees charged on long-term financial arrangements can occur in a number of different ways with very different implications for their ultimate value. In the case of pensions the following fee structures exist:

- Fixed sum payable up front;
- Fixed sum payable at the end of a period;
- On-going fees per period;
- Fixed fee per period;
- Percentage of contribution;
- Percentage of assets in the fund.

These structures can be applied individually or in combination, making it very difficult to assess their impact on the value of the pension at any point in time. The most useful measure is a calculation based on a full lifetime (Whitehouse, 2001, p.11).

Whitehouse (2001, pp.13-14) proposes four measures of charges for pensions:

- **Reduction in yield:** “shows the effect of charges on the rate of return, given a set of assumptions about the rate of return, the time profile of contributions and the term of the plan.”

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- **Reduction in premium:** “shows the charge as a proportion of contributions, again for a set of assumptions about investment returns etc.”
- **MP1 (managed portfolio):** “is the price of a managed portfolio that yields the market return, excluding charges, on £1.”
- **Charge ratio:** “defined as one minus the ratio of the accumulation net of charges to the accumulation without charges.”

Whitehouse (2001, p.25) qualifies the use of any of the above measures, saying that no simple measure can accurately reflect the different fees levied on financial products. “Our concern should therefore be to minimize the loss of precision in this process of simplification.”

“When comparing funds or systems which rely on different types of charge, reliance on a single measure can be misleading, and the best approach is to use both the charge ratio and the charge as a proportion of assets.” (Whitehouse, 2001, p.26).

The analysis provided below focuses on showing the charge ratio and reduction in yield indicators of performance.

2.6.3 Review by Rusconi

To date, there are no studies on retirement fund costs in South Africa other than a single report submitted to the Actuarial Society of South Africa (ASSA) by Rusconi (2004). This section discusses

the results of that study and its implications. For the full methodology readers are referred to the report itself.

Table 12 summarises the central results of the report and compares these to the information provided by the Registrar of Pension Funds. The costs provided by Rusconi compare a wide range of products based on alternative periods of contribution (10 years, 20 years, 30 years and 40 years). The costings are based on actual costs provided and modeled on two standard policyholders assumed to be earning annual salaries of R24,000 and R120,000 respectively at the start date of the calculation. They contribute 10% of gross income to retirement savings which amounts to R200 and R1,000 per month for the two income groups respectively. (Rusconi, 2004, p.87).

The methodology used by Rusconi to estimate the costs over time involved obtaining information that is not available to the general public. The sample of contracts used involved the largest firms in the country offering retirement services and products. The assessment did not analyse costs associated with “investment switches, for policy changes and for early termination.” (Rusconi, 2004, p.88). Given that these are very prevalent in the market, the costs provided must therefore be regarded as an underestimate. How significant this underestimate is cannot be determined due to the lack of information

Table 12: Results from Rusconi (2004) compared to the annual report of the Registrar of Pension Funds (2002 and 2003)

| Estimate | Type of fund | Charge ratio | Reduction in yield |
|-----------------------------|--|------------------|--------------------|
| Rusconi | Self-administered funds: core range | 17.0% and 27.1% | 1.04% to 1.65% |
| Rusconi | Self-administered funds: outside range | 13.4% and 38.7% | 0.81% to 2.36% |
| Rusconi | Individual funds: all results | 26.7% to 43.2% | 1.5% to 2.8% |
| Rusconi | Unit trusts: all funds | 22.3% to 32.5% | 1.2% to 1.95% |
| RPF (2002) | Self-administered funds | 13.1% | 0.87% |
| RPF (2003) | Self-administered funds | 11.5% | 0.81% |
| Assessment by Firm | | | |
| Firm A (Retirement annuity) | 10 years: range R200 to R1,000 | 19.61% to 16.24% | 4.69% to 3.80% |
| | 20 years: range R200 to R1,000 | 28.06% to 25.05% | 3.45% to 3.00% |
| | 30 years: range R200 to R1,000 | 36.00% to 33.31% | 3.30% to 2.74% |
| | 40 years: range R200 to R1,000 | 43.38% to 41.01% | 2.82% to 2.60% |
| Firm A (Provident fund) | 10 years: range R200 to R1,000 | 14.65% to 11.63% | 3.37% to 2.64% |
| | 20 years: range R200 to R1,000 | 17.01% to 14.71% | 1.92% to 1.63% |
| | 30 years: range R200 to R1,000 | 21.56% to 19.55% | 1.61% to 1.44% |
| | 40 years: range R200 to R1,000 | 26.58% to 24.76% | 1.49% to 1.37% |
| Firm B (Retirement annuity) | 10 years: range R200 to R1,000 | 18.09% to 14.34% | 4.28% to 3.31% |
| | 20 years: range R200 to R1,000 | 23.19% to 19.71% | 2.74% to 2.27% |
| | 30 years: range R200 to R1,000 | 28.31% to 25.10% | 2.23% to 1.93% |
| | 40 years: range R200 to R1,000 | 33.78% to 30.83% | 2.10% to 1.79% |
| Firm C (Retirement annuity) | 10 years: range R200 to R1,000 | 23.98% to 17.94% | 5.92% to 4.25% |
| | 20 years: range R200 to R1,000 | 30.87% to 19.71% | 3.88% to 3.26% |
| | 30 years: range R200 to R1,000 | 37.88% to 34.68% | 3.24% to 2.88% |
| | 40 years: range R200 to R1,000 | 44.13% to 41.45% | 2.89% to 2.64% |
| Firm D (Retirement annuity) | 10 years: range R200 to R1,000 | 21.08% to 18.89% | 5.10% to 4.50% |
| | 20 years: range R200 to R1,000 | 31.47% to 29.51% | 3.98% to 3.67% |
| | 30 years: range R200 to R1,000 | 37.62% to 35.87% | 3.21% to 3.02% |
| | 40 years: range R200 to R1,000 | 43.30% to 41.74% | 2.81% to 2.67% |
| Firm D (Provident fund) | 10 years: range R200 to R1,000 | 18.48% to 15.19% | 4.39% to 3.53% |
| | 20 years: range R200 to R1,000 | 25.59% to 23.44% | 3.08% to 2.78% |
| | 30 years: range R200 to R1,000 | 33.21% to 31.28% | 2.73% to 2.52% |
| | 40 years: range R200 to R1,000 | 40.37% to 38.65% | 2.55% to 2.40% |

Sources: The results by firm are based on Rusconi, 2004, table A2, 'South African life policy cost ratios for different periods of saving', p.125. These figures are indicated at the 'mid-point of asset management fee range'. The results against the name 'Rusconi' are from Rusconi, 2004, table 15, 'Summary comparison of South African savings channels', p.105. The results against 'RPF (2002)' and 'RPF (2003)' are from the Annual Report of the Registrar of Pension Funds for 2003.

The disturbing findings from the analysis show that amongst self-administered funds, the most important private retirement arrangement, the cost ratios range from 17,0% to 27,1% in the core range and

from 13,4% to 38,7% in the outside range. These poor cost results however look 'good' compared to individual products which show cost ratios ranging from 26,7% to 43,2%.

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The problematic nature of these expenses are not revealed in the reported statistics of the Registrar of Pension Funds, where it is reported that the administration costs were around 13.1% in 2002 and 11.5% in 2003.

According to Rusconi, these high costs are caused by poor transparency and a resulting lack of price competition. In this instance the true 'price' of a product is reflected by the cost ratio or the 'reduction in yield'.

"A valid concern is that the main cause of these high charges is a lack of transparency and a lack of competition. While the link between transparency and cost is an often studied field, not always with conclusive results, it is difficult to argue against clear charge information to the consumer." (Rusconi 2004, p.97).

The results show the following (Rusconi, 2004, pp.90-91 (note that the footnotes in the original text are not included))

"Charges are high: The mean unweighted reduction in yield across all six contracts for policies with contributions starting at R200 per month is 2.43% per year and the equivalent charge ratio 38.6%. This means that, over a 40-year period, nearly two-fifths of the policy value is lost to charges."

- **"Charges are higher for small policies:** Not surprisingly, owing to the fixed component of the policy fee, ratios are higher for low-contribution policies. The equivalent average reduction in yield for policies starting at R1 000pm is 2.24% and the charge ratio is a little above 36%. All contracts show this effect to some extent, depending upon the relationship between fixed and variable costs."
- **"The provident fund arrangements are cheaper than their retirement annuity counterparts:** The firms that offer both retirement annuities and provident funds have succeeded in providing a

cheaper alternative to the retirement annuity, ... the average cost for the two provident funds is also lower than the corresponding average for the four retirement annuity products."

- **"Three of the retirement annuity products have very similar charges:** One firm offers by far the best value for money in a retirement annuity. The other three retirement annuities are remarkably close in their charging levels, despite having very different charging structures. Differences are greater at shorter policy terms ..."
- **"The range of costs is high:** The difference between the cheapest and the most expensive might be regarded as unacceptably high, particularly as the impact of cost is unlikely to loom large in the minds of most policyholders. On a reduction in yield basis, the most expensive contract is nearly twice as costly as the cheapest."

Consistent with international experience Rusconi also found clear evidence of a negative relationship between fund size and administration costs as a proportion of contributions. "In each case the regressed ratio for a fund with 40 members is twice the corresponding ratio for a fund with 700 members." (Rusconi, 2004, p.83).

2.6.4 Sensitivity of retirement arrangements to administrative charges

Rusconi's 2004 study analysed the costs of various retirement fund providers by focusing on two fairly low-income individuals where the incomes remain constant in real terms through time. This assumption is limiting, and fails to indicate the cost dynamics of an individual whose income rises significantly through their lifetime. This section therefore looks at the sensitivity of retirement fund performance to a broader range of factors experienced in the market.

The outcome measures used in this assessment are the 'cost ratio' and the 'replacement rate'.

The following factors are assessed:

- Income changes through time;
- Differences by income group; and
- Alternative contribution configurations.

2.6.5 Income changes

To assess what happens to retirement cost ratios and replacement rates for alternative increases in

income, all other assumptions are kept constant. Three individuals with a starting income of R50 000 per annum are modeled, with real annual income growth of 0,0%, 2,0% and 4,0% respectively. It is assumed that all three contribute 20% of their income over a 40-year period to retirement. Total expenses charged as a percentage of contribution are assumed at 11,8% of retirement contribution for all three. Charges for asset management are assumed at 0,6% of assets for all three. The analysis assumes a defined contribution retirement fund.

Table 13: Impact of alternative income increases on retirement charges and replacement rates

| Income: start pre-tax | | 50,000 | 50,000 | 50,000 |
|--|--|-----------------------------------|------------|------------|
| Assumptions | Income increase (real % pa) | 0.0% | 2.0% | 4.0% |
| | Income increase (nominal % pa) | 5.0% | 7.0% | 9.0% |
| | Pension contribution (% of pre-tax income) | 20.0% | 20.0% | 20.0% |
| | Interest rate (real % pa) | 5.0% | 5.0% | 5.0% |
| | Interest rate (nominal % pa) | 10.0% | 10.0% | 10.0% |
| | Inflation | 5.0% | 5.0% | 5.0% |
| | Fee: Contribution (% of contribution) | 9.0% | 9.0% | 9.0% |
| | Other costs: (% of contribution) | 2.8% | 2.8% | 2.8% |
| | Expenses total: (% of contribution) | 11.8% | 11.8% | 11.8% |
| | Fee: Contribution (% of pre-tax income) | 2.4% | 2.4% | 2.4% |
| | Fee: % of assets | 0.6% | 0.6% | 0.6% |
| | Value of tax on interest earnings(%) | 7.0% | 7.0% | 7.0% |
| | Results | Income: Final (pre-tax) (nominal) | 335,238 | 699,741 |
| Income: Final (pre-tax) (yr1 prices) | | 50,000 | 104,365 | 214,892 |
| Accumulation: with charges (nominal) | | 5,624,446 | 7,629,271 | 10,763,804 |
| Accumulation: without charges (nominal) | | 8,408,239 | 11,104,426 | 15,234,819 |
| Accumulation: with charges (yr 1 prices) | | 838,875 | 1,137,890 | 1,605,399 |
| Cumulative expenses at retirement | | 2,783,792 | 3,475,155 | 4,471,015 |
| Retirement income (nominal) | | 418,131 | 567,173 | 800,200 |
| Retirement income (yr 1 prices) | | 62,363 | 84,593 | 119,348 |
| Charge ratio (incl. tax) | | 33.1% | 31.3% | 29.3% |
| Replacement rate (LE = 25yrs) | | 124.7% | 81.1% | 55.5% |

The results show that replacement rates tend to decline with increases in income, with cost ratios at their highest (33.1%) for the individual with 0.0% income growth. The lowest cost ratio is 29.3%. All

three are very high and imply that a third of the potential accumulation at retirement has been subsumed in expenses.

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The decline in replacement rates is caused by income growth being greatest in value terms in the period approaching retirement. To achieve a closer match to the replacement rate in a defined

contribution scenario, contribution rates in the latter years would have to increase to compensate for the increased income.

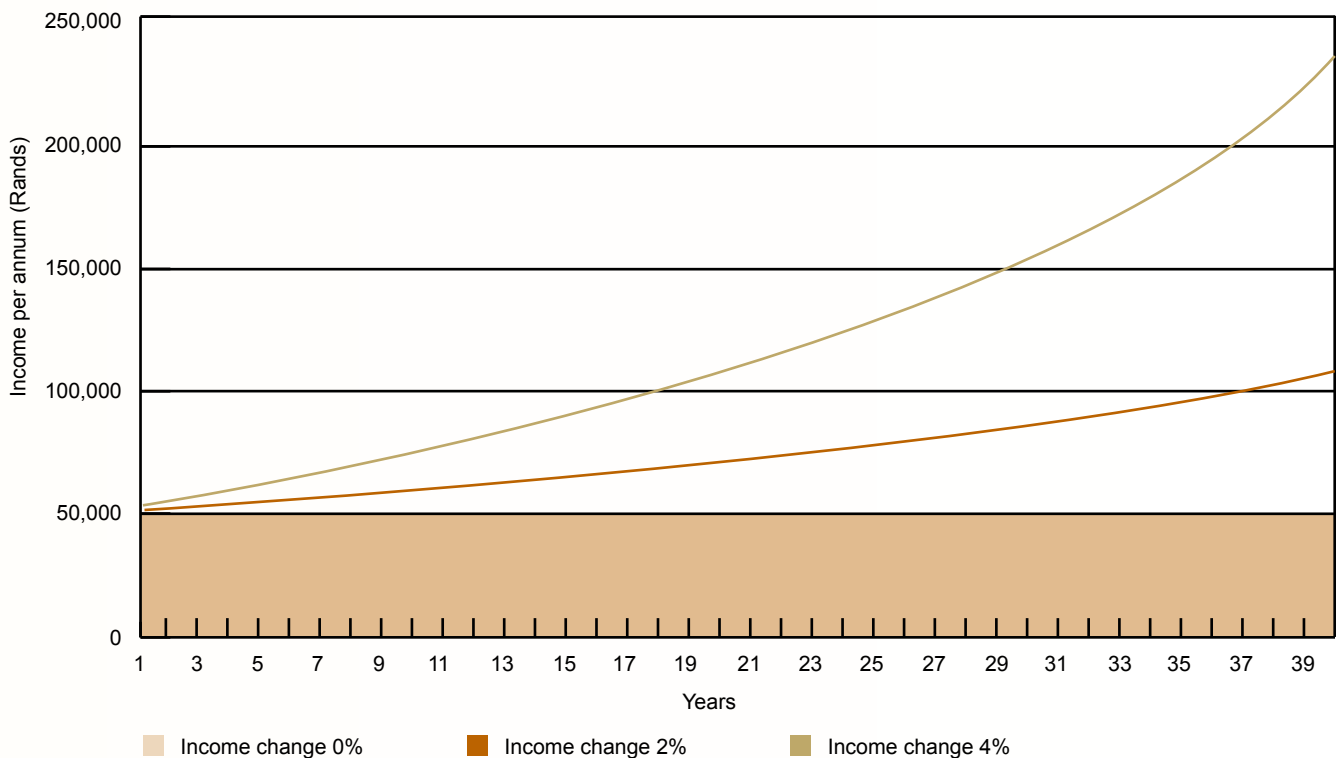


Figure 10: Income growth at alternative growth rates over a 40-year period starting from a single annual income level of R50 000

2.6.6 Income differences

Cost ratios and replacement rates are apparently not affected by differences in the starting income (when all other assumptions remain constant).

2.6.7 Alternative contribution configurations

In the following table four alternative contribution configurations are considered, with all other assumptions kept constant. These are:

- Contributions for a period of 40 years, starting at age 25 ('25-65' in the table);
- Contributions only begin from age 40 until 65; which is consistent with the proposal for mandatory contributions in the Taylor Committee report ('40+ Taylor' in the table);
- Contributions begin from age 25 until age 39 where they are discontinued for 5 years; thereafter they continue at the same rate as before until age 65 ('25-39 and 46-65' in the table); and
- Contributions begin from age 25 until age 39 where they are discontinued for 10 years;

thereafter they continue at the same rate as before until age 65 (25-39 and 50-65).

The contribution rate is assumed at 10% for all four scenarios, with real income increases at 5% per

annum. In constant prices income consequently rises from an annual R50 000 to R306 883 (R2,5 million in nominal prices) in all scenarios.

Table 14: Alternative contribution configurations, incorporating alternative start periods, and breaks in contribution (without draw-down): pension contribution rate = 10%

| Alternative contribution configurations | | 25-65 | 40+ (Taylor) | 25-39 and 46-65 | 25-39 and 50-65 |
|--|--|-----------------------------------|---------------|-----------------|-----------------|
| Pension contribution = 10% of pre-tax income | | | | | |
| Assumptions | Income: start pre-tax | 50,000 | 50,000 | 50,000 | 50,000 |
| | Income increase (real % pa) | 5.0% | 5.0% | 5.0% | 5.0% |
| | Income increase (nominal % pa) | 10.0% | 10.0% | 10.0% | 10.0% |
| | Pension contribution (% of pre-tax income) | 10.0% | 10.0% | 10.0% | 10.0% |
| | Interest rate (real % pa) | 5.0% | 5.0% | 5.0% | 5.0% |
| | Interest rate (nominal % pa) | 10.0% | 10.0% | 10.0% | 10.0% |
| | Inflation | 5.0% | 5.0% | 5.0% | 5.0% |
| | Fee: Contribution (% of contribution) | 9.0% | 9.0% | 9.0% | 9.0% |
| | Other costs: (% of contribution) | 2.8% | 2.8% | 2.8% | 2.8% |
| | Expenses total: (% of contribution) | 11.8% | 11.8% | 11.8% | 11.8% |
| | Fee: Contribution (% of pre-tax income) | 1.2% | 0.0% | 1.2% | 1.2% |
| | Fee: % of assets | 0.6% | 0.6% | 0.6% | 0.6% |
| | Value of tax on interest earnings(%) | 7.0% | 7.0% | 7.0% | 7.0% |
| | Results | Income: Final (pre-tax) (nominal) | 2,057,239 | 2,057,239 | 2,057,239 |
| Income: Final (pre-tax) (yr1 prices) | | 306,833 | 306,833 | 306,833 | 306,833 |
| Accumulation: with charges (nominal) | | 6,485,424 | 4,394,849 | 5,704,497 | 4,877,340 |
| Accumulation: without charges (nominal) | | 9,051,851 | 5,657,407 | 7,920,370 | 6,788,888 |
| Accumulation: with charges (yr 1 prices) | | 967,288 | 655,483 | 850,814 | 727,445 |
| Cumulative expenses at retirement | | 2,566,427 | 1,262,557 | 2,215,873 | 1,911,548 |
| Retirement income (nominal) | | 482,138 | 326,721 | 424,082 | 362,590 |
| Retirement income (yr 1 prices) | | 71,910 | 48,730 | 63,251 | 54,080 |
| Charge ratio (incl. tax) | | 28.4% | 22.3% | 28.0% | 28.2% |
| Replacement rate (LE = 25yrs) | | 23.4% | 15.9% | 20.6% | 17.6% |

Overall the replacement rate is very low for all scenarios, with the Taylor Committee option being the lowest at 15,9%. What is useful to note is how easy it would be for a purchaser of an annuity with such a configuration to be substantially confused about the benefits and security offered. The 10% contribution rate is often recommended as a standard in the industry. An individual who experiences

considerable income growth in their lifetime, e.g. qualified professional, would not accumulate sufficient income to maintain their standard of living at retirement. The impact of the 5% inflation rate would also significantly confuse an individual into believing that they were going to be well off in retirement which is not the case.

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The charge ratios are roughly similar in all scenarios, at around 28%, except for the Taylor Committee proposal which results in a charge ratio of 22.3%. These charges are all very high and are indicative of the current market cost levels.

2.6.8 Concluding remarks

Although this section only touches the surface of the issue of administration charges in the South African system of private retirement, a number of areas of serious concern can be identified:

- Administration expenses reflect the price that people must pay to get access to a retirement savings vehicle. A pre-condition for a properly functioning market of any form is that the price is transparent, thereby providing a basis for the choice of alternative service providers. In South Africa today the evidence suggests that virtually all pension fund members pay charges way in excess of international norms.
 - The lack of transparency in the market occurs because no requirement is placed on retirement arrangements to reflect their 'price' to potential and existing members. It is very difficult not to draw the conclusion that this information is deliberately kept out of sight to prevent it from becoming a basis for competition.
 - The lower end of charges involves charge ratios of the order of 20%; while the upper end is upward of 40%. In 2005 this would roughly compare to a present value of administration charges of between R200 – 400 billion based on the value of existing assets under management.
 - The impact of inflation, administration costs and income changes on final replacement rates and costs makes it virtually impossible for anyone to understand the implications and value of a retirement arrangement available at the time of purchase.
- Incomes that increase (or are likely to increase) significantly over the lifetime period of employment will face declining replacement rates where contribution rates remain constant through time. Charge ratios, however, decline with increases in income where all other variables remain constant.
 - Costs are systematically higher for smaller funds. Given this, private retirement contributors are paying a significant premium for the lack of pooling – roughly equivalent to around 20% of the potential final payout. This assessment probably affects around 65% of retirement fund members.

2.7. SUBSIDY FRAMEWORK

2.7.1 Overview

Existing subsidies within the retirement framework take two forms. The first involves the 'on-balance-sheet' allocations from general tax revenue to fund the means-tested SOAP. The second takes the form of an 'off-balance-sheet' system of Tax Expenditure Subsidies (TESs) for individuals contributing to private retirement arrangements. The latter is heavily biased toward higher-income individuals and raises significant equity and efficiency questions.

2.7.2 Subsidy framework for private retirement arrangements

The South African tax regime anachronistically is the only mechanism for providing subsidies to contributory retirement provision. The subsidy is allocated to allow individuals the ability to deviate from the progressive personal income tax regime on the basis of their contributions to a retirement fund arrangement of one form or another. This deviation from personal income tax alters the dis-

tribution of the tax burden in favour of retirement fund contributors, effectively providing a financial transfer to beneficiaries. Tax subsidies (or TESs) disproportionately benefit higher income groups. This results in a distorted subsidy to higher income groups.

Section 4 of Chapter 1, indicates that ETT* (ex-empt, tax, tax) or TEE** tax regimes for retirement can be superficially regarded as equivalent to a consumption tax which is regressive and consequently favours higher income groups. South Africa currently has an ETT structure with a very low tax rate on retirement fund interest earnings of 9%. This is a recent arrangement, as until 2006 an 18% tax on interest earnings was in place. This change has altered the balance significantly in favour of higher-income groups.

Calculating the true value of this subsidy is difficult. This is primarily due to the inconsistent participation to maturity of retirement fund members. Even so, it would not be unreasonable to assume that those who participate for longest and receive most of the benefits, are systematically those of higher income groups. Despite estimation difficulties an attempt to quantify the subsidy is needed, and proved below.

According to the Income Tax Act the maximum deduction that can be claimed for a pension fund contribution is 7.5% of *pensionable remuneration* or R1,750, whichever is the greatest. An employer contribution to a pension fund, provident fund or benefit fund is deductible *“if the contributions (including any lump sum payments) made by the employer in respect of any employee during any year of assessment to such funds exceed an amount equal to ten percent of the approved remuneration*

of such employee for such year of assessment ...” (Income Tax Act, 1962, Section 11(l)(ii)).

Based on these provisions an employee is able to achieve a maximum deduction of 17.5% of approved income.

Contributions to a retirement annuity qualify for a maximum deduction of whichever is the greatest of “15 per cent of an amount equal to the amount remaining after deducting from, or setting off against, the income derived by the taxpayer during the year of assessment”, “the amount ... by which the amount of R3,500 exceeds the amount of any deduction to which the taxpayer is entitled under paragraph (k)(i) in respect of the said year”; or “the amount of R1,750” (Income Tax Act, 1962, Section 11(n)(aa)).

Thus, where an individual contributes to an individual retirement annuity they can claim up to 15% of their income. This ceiling can be pierced where incomes are such that the Rand amounts referred to exceed the percentage deduction.

2.7.3 Estimate of the Tax Expenditure Subsidy

This section makes a rudimentary attempt to estimate the value of the TES in 2005 prices. The calculation of the overall subsidy requires the separate estimate of the tax benefit on contributions and that on interest earnings. The calculation performed in this section is high-level and not intended as definitive.

2.7.4 Assumptions

The calculation of the contribution subsidy has been determined as follows:

- All financial estimates are based on 2005.

* Contributions are not taxed, but lump sums and monthly pay-outs are.

** Contributions are taxed, but lump sums and monthly pay-outs are not.

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- The subsidy is calculated exclusively in terms of the economically active population within the age range 25-64. People over the age of 65 are regarded as retired and no longer relevant for the purposes of calculating any subsidy.
- It is assumed that on average all contributing income groups contribute around 11.4% of their income toward retirement. This is a derived value that is calculated based on the reported value of retirement contributions expressed as a percentage of household income for people in the age range 25-64.
- It is assumed that the entire contribution is deductible. This assumption is regarded as valid as most people in the formal sector try to maximise their tax efficiency when contributing to retirement.
- The contributing population and their income distribution is based on a distribution from the Census 2001 (Stats SA) with income bands inflated to 2005. The estimated number of current contributors (see table 3.2) is distributed from the highest income bands to the lowest until the total is exhausted. This is regarded as a reasonable assumption to make, with a resulting income distribution of retirement fund contributors that must be close to reality.
- The tax deduction on contributions is regarded as deferred (postponed) rather than foregone (lost) taxation. However, a tax benefit would have been obtained where the tax rate applicable pre-retirement was the same post-retirement. This is not the case as there is a significant drop in income coupled with a reduced taxation of retirees. To accommodate this issue, it is assumed that the value of the tax deduction gained pre-retirement is offset by the deferred tax of that benefit in retirement at a lower

average tax rate. It is assumed that income levels decline in retirement resulting in deferred taxation that is lower than during employment. The lowered tax rates are assumed to result in a general 45% reduction in taxation during retirement. Thus, the value of the tax benefit, in aggregate, is assessed as 45% of the value tax deduction during employment. This is probably quite conservative.

The calculation of the tax subsidy on retirement investment earning is based on the following assumptions:

- The cumulative return on investment (ROI) on the total value of reported assets under management in retirement funds is calculated for 2005 in respect of current (pre-retirement) members only.
- To calculate the nominal ROI a real interest rate of 3% is assumed with inflation at 4%. The nominal rate is used because the taxation of retirement fund returns ignores inflation.
- The tax rate of retirement investment income (i.e. the ROI), assumed to be roughly equal to personal income tax, is taken as the weighted average of the taxes that should be paid by the range of income groups contributing to retirement funds. This comes to 23,2%. Any rate lower than this is assumed to generate a tax subsidy to some income groups. It should be noted, however, that even at 23,2% a subsidy is generated for income groups where the effective marginal tax rate exceeds this percentage. Prior to March 2006 the applicable tax in retirement investment returns stood at 18%, which is below this figure and consequently implied a subsidy. At a tax rate of 9% a fairly significant subsidy is generated.

2.7.4.1 Estimate of the Tax Expenditure Subsidy on contributions (2005)

The effective contribution subsidy for retirement

provided is estimated at R32 billion in 2005. When adjusted for deferred taxation, the estimated subsidy declines to R17.6 billion or 1.2% of GDP (see **table 15**).

Table 15: Estimate of the TES on Retirement Contributions

| | |
|--|---------------|
| GDP (market prices) (R'm) | 1,495,737 |
| Aggregate Household Income: 20-64 (R'm) | 1,025,715 |
| Aggregate Retirement Contribution (R'm) | 117,043 |
| % of Household Income | 11.4% |
| Tax Subsidy on contributions before adjustments (R'm) | 31,996 |
| Tax Subsidy adjusted for deferred taxation (R'm) | 17,598 |
| % of GDP (market prices) | 1.2% |
| % assumed general reduction in incomes into retirement | 45% |

2.7.4.2 Tax subsidy on investment earnings

The subsidy allocated in respect of investment earnings is valued at R10.9 billion in 2005 where the tax rate is set at 9%. Were there to be a 0% tax, the subsidy would be valued at roughly R17.8 billion.

The value of the subsidy is also linked to the estimated rate of return (ROI), which assumes a 3% real return and 4% inflation. The assumed 3% ROI is regarded here as a long-term return, accounting for earnings fluctuations. However, the

assumed rate is material as can be seen from **table 17**, where subsidies associated with increasing rates of return dramatically increase the value of the subsidy. For instance a 10% ROI results in a R5,6 billion increase in the subsidy. The Registrar of Pensions reports ROI considerably higher than the assumed 7% with only one year in the past 5 reporting a lower value (see **table 18**). In 2004 the ROI was 21%. Therefore, the assumed ROI for the purposes of producing the estimate here must be regarded as conservative.

Table 16: TES on Retirement Investment Earnings (2005)

| Tax on ROI (%) | 0.0% | 9.0% | 23.2% |
|-------------------------------|--------|-----------|--------|
| Value of Tax Obligation (R'm) | 0 | 6,917 | 17,867 |
| Value of Subsidy (R'm) | 17,867 | 10,949 | 0 |
| % of ROI | 23.2% | 14.2% | 0.0% |
| Assets under management (R'm) | | 1,098,000 | |
| ROI (R'm) | | 76,860 | |
| ROI (%) | | 7.0% | |
| Real (%) | | 3.0% | |
| Inflation (%) | | 4.0% | |

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Table 17: Effect of alternative ROI assumptions on the value of the TES on Retirement Investment Earnings (2005)

| Alternative ROI | Subsidy (R'm) |
|-----------------|---------------|
| 7% | 10,949 |
| 8% | 12,514 |
| 9% | 14,078 |
| 10% | 15,642 |
| 11% | 17,206 |
| 12% | 18,770 |
| 13% | 20,335 |
| 14% | 21,899 |
| 15% | 23,463 |

Table 18: Return on Investment within Self-administered Funds as Reported by the Registrar of Pensions (2004)

| Years | ROI | Assumption used |
|-------|-------|-----------------|
| 2000 | 15.2% | 7.0% |
| 2001 | 16.4% | |
| 2002 | 8.7% | |
| 2003 | 0.7% | |
| 2004 | 21.5% | |

Source: Registrar of Pension Funds, 2004, p.7

2.7.4.3 Combined tax subsidy provided to the private contributory retirement system

Combining both the contribution subsidy and the subsidy on retirement investment earnings comes

to R28,5 billion or 1,9% of GDP. The overall subsidy to private retirement arrangements, a numerically smaller and less excluded group, potentially exceeds the value of the SOAP of R9 billion.

Table 19: Combined Tax Subsidy provided to the private contributory retirement system (2005) (R'm)

| | |
|--------------------------------------|---------------|
| TES on Contributions | 17,598 |
| TES on Investment Returns | 10,949 |
| Total | 28,547 |
| <i>% of GDP (market prices)</i> | <i>1.9%</i> |
| SOAP estimated for 2005 | 19,486 |
| Amount by which TES exceeds the SOAP | 9,061 |

2.7.4.4 Value of a Universal SOAP

To put the nature of the existing subsidy framework into context, the value of universalising the SOAP relative to the existing subsidy framework is worth estimating. This is done here by calculating the population with females over the age of 60 and males over the age of 65 outside of the SOAP. As the total population in this category is known from the census, the difference between this and existing SOAP beneficiaries is calculated and amounts to 889 573. It is this latter group that

is currently the beneficiary of the tax subsidy of around R28,5 billion.

Were the SOAP to be universalised, i.e. the means test removed, the total cost of the grant would be valued at approximately R27,7 billion (2005). If the subsidy to private retirement were removed entirely and replaced by this allocation, coupled with a mandate (rather than an incentive) to join a retirement fund, Government would save R20,3 billion annually and potentially improve on existing levels of private participations.

Table 20: Estimate of SOAP when applied as a universal grant (2005)

| | |
|---|------------------|
| Population: females 60+ and males 65+ | |
| SOAP beneficiaries | 2,106,327 |
| Not on SOAP | 889,573 |
| Total population | 2,995,900 |
| Grant estimates (R'm) | |
| SOAP beneficiaries | 19,486 |
| Retirees not on SOAP | 8,230 |
| Total retirees (females over 60) | 27,715 |

2.7.4.5 Discussion and findings

The value of the existing subsidy to higher income households, even with conservative assumptions, is considerably larger than that of the targeted subsidy to the lowest income households. The difficulty involved in calculating an explicit value for the TES is particularly concerning. Given the substantial financial implications, the lack of any explicit quantification is problematic from a Governance perspective, as Parliament has no understanding of the financial implications of this measure.

If it were found that the removal of the tax subsidy only altered the vehicle people used for the purposes of saving, rather than becoming discouraged from saving, the entire allocation of this subsidy to higher

income groups would be brought into question.

Chapter 1 (section 4) the key conclusions of international World Bank economists are that no basis exists for using the tax system to encourage private savings.

“Even with the incentive, people may not save enough. It is hard to define what is a ‘sufficient’ retirement income, beyond a reasonable minimum. The best way of being paternalist is mandating minimum retirement savings, either through state provision (the ‘first pillar’) or compulsory contributions to private funds (the ‘second pillar’)” (Whitehouse, 2001, pp.3-4).

The following conclusions arise:

- There is no basis for the current tax subsidy

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to private retirement funds, as the only rational and fair mechanism for achieving this is through mandates;

- There is no basis for allocating a subsidy to higher income groups substantially in excess of that given to the lowest income groups.

2.8. POST-RETIREMENT MEDICAL SCHEME COVER AND CONTRIBUTION PROTECTION

2.8.1 Overview

As already noted elsewhere in this report, many people face a significant decline in income going into retirement. Most families that rely on their retirement savings to provide sufficient income in retirement struggle to continue participating in a medical scheme. This period in their lives often coincides with an increase in healthcare needs, particularly in relation to chronic conditions.

In the past many employers supported their post-retirement group, but in the past 10 years many have begun to remove this support. In some instances this involved going back on past promises, but in the bulk of cases it involved the removal of this benefit in respect of current employees. In view of the fact that these benefits are related to medical scheme contribution costs rather than income replacement, it could be said that the funding implications are less onerous than conventional retirement requirements. The retrenchment of these benefits by employers over a relatively short period reflects the need to have more robust social security measures in place other than the goodwill of employers.

2.8.2 Trends over time

According to the Old Mutual 2005 Health Survey (p.42) the shift toward excluding healthcare benefits

by employers began in 1997 with the introduction of the AC116 accounting standard. This standard required that medical scheme post-retirement liabilities be reflected in company financial statements.

“Although not mandatory at the time, it created an awareness of the potential size of the liability that would impact on company balance sheets. Over the ensuing 8 years we have seen how employers have reduced their share of the cost of pensioner healthcare in a number of ways:

- *“Excluding healthcare benefits in retirement from employment contracts of all new employees”;*
- *“Capping employer contributions for all future as well as existing pensioners”;*
- *“Offering cash or other benefits in lieu of continuing to cover the liability of post retirement medical scheme contributions”;*
- *“Re-designing the medical scheme benefit structure or imposing limitations on benefits”.*

Out of 100 employers with more than 200 employees, the Old Mutual survey (2005) found that only 58% provided some form of post-retirement cover. However, 9 companies (9% of the total sample) did not offer the subsidy to employees after a designated date. (Old Mutual, 2005, p.41). Given this, only 49% of the companies surveyed actually provided adequate post-retirement benefits. It should be noted that post-retirement protection was virtually 100% prior to 1997.

The rapid stripping away of post-retirement subsidies is closely related as much to the AC116 provision as to the advice employers were given to deal with

the provision. Employer financial/employee benefit advisors, i.e. “brokers”, made use of the AC116 provision to recommend substantial changes to both retirement and healthcare provision. The following advice range was typical:

- Convert the defined benefit (DB) pension fund into a defined contribution (DC) fund;
- Repatriate any retirement fund surplus (as calculated by the actuarial consultants working for, or closely linked to the employee benefit advisors) to the employer;
- Utilize a portion of the repatriated surplus to establish a “pre-funding” reserve to offset the identified AC116 liability;
- Absorb any residual surplus back for use by the employer;
- Cap any post-retirement subsidy obligation by:
 - Going back on promises made to provide the subsidy to current retired individuals; or
 - Eliminating such promises for new employees;
 - Converting the subsidy into a capped Rand amount, which would increase only with normal inflation (this altered earlier arrangements where employers promised to subsidise a given percentage of medical scheme contributions);
- Adjust medical scheme entitlements by:
 - Closing any existing restricted membership (closed) employer-based medical scheme, which had income-based contribution tables (which protected pensioners from any decline in post-retirement income) and moving to an open scheme where contribution rates are risk-rated, and cheaper options favour younger-and-healthier (i.e. current employees) members only, prejudicing the post-retirement group; or
 - Following (a) and splitting the pre- and post-retirement group, moving the former to an open scheme and leaving the latter in a now non-viable closed scheme, with Rand caps placed on the post-retirement subsidy to retired members (here at some point the cost would become so high for the retired members that they would drop out of cover entirely, eliminating the employer liability); or
 - Retaining the closed scheme but significantly reducing the benefit entitlements to reflect the coverage requirements of existing younger-and-healthier employees, leaving pensioners without adequate cover.

The employee benefit advisors who strongly promoted the abovementioned strategies often had significant conflicts of interest, with vested interests in the chosen configurations. These included:

- Benefiting from substantial commission-related revenue for shifting beneficiaries from closed to open medical schemes; and
- Gaining significant assets under management for converting pay-as-you-go arrangements into funded arrangements. This was relevant in respect of medical scheme subsidy arrangements which, as a consequence of the AC116 provision, created the appearance of an obligation to fund the liability.

After AC116 came in (around 1997) the shift from closed to open (commercial) medical schemes was extremely rapid, slowing somewhat only after the introduction of the **Medical Schemes Act 131 of 1998** (which effectively came into force largely from

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2000). Open scheme membership now stands at 70% of the market, up from around 40% in the mid-1990s. Much of this shift has been accompanied by a decline in benefits and significant prejudice to pensioners.

2.8.3 Retirement Forum

An initial tendency, occurring around 1997 and 1998, was for certain employers to “fund” their post-retirement obligation through the accumulation of reserves in their medical scheme. This approach was rejected by the Department of Health which saw it as merely an attempt to obtain a tax advantage not available to existing retirement vehicles. These reserves were seen as distorting the true nature of the scheme, as medical schemes are essentially short-term insurance arrangements. Furthermore, the regulatory framework was not consistent with that of a long-term savings arrangement.

The Consultative Retirement Forum, convened in 1997 by the Department of Finance and the Department of Health, agreed that all medical scheme post-retirement funding should occur outside of medical schemes in a properly regulated entity. No specific tax privilege was proposed for these arrangements, as it was seen as a part of the existing retirement provision for which a tax regime required a holistic approach.

The **Medical Schemes Act 131 of 1998** consequently did not make provision for these reserves and schemes were required to remove these funds, where they were established, over time. However, post-retirement funding arrangements remained problematic as many employers created maverick arrangements, motivated primarily by tax considerations. The employee entitlements in respect of these funds were varied, with employers retaining full control in some instances.

2.8.4 Concluding Remarks

Only 49% of large employers (those with more than 200 employees) provide post-retirement medical scheme subsidies in respect of current employees. Around 58% of large employers currently provide some post-retirement subsidy. Of these roughly 22% of employers have set aside the full amount to cover this liability (based on the Old Mutual Survey, 2005).

The central social security consideration is the continuation of effective employer subsidies into the post-retirement period rather than whether these are funded. There is also a need to protect the contributions of dependants in the case of the death or disability of the employee.

The arrangements used by employers to pre-fund post-retirement medical scheme obligations are fragmented, lack transparency (where these are provided outside of a conventional retirement fund), and are generally not transferred when employment switches occur.

In the absence of a more effective arrangement coming into being to protect post-retirement contributions, it is likely that the existing declining trends in protection will persist.

2.9. REGULATORY FRAMEWORK

The private retirement system in South Africa in 2005 had R1 trillion under management in around 14,000 funds. The existing regulatory authority cannot reasonably be assumed to be providing adequate protection.

Many of the regulatory problems identified in the market can be traced back to the following issues:

- Poor governance arrangements;

- Permitted conflicts of interest amongst:
 - Financial advisors to individuals;
 - Employers and trustees;
 - Employers and administrators; and
 - Consultants to trustees and employers;
- Weak oversight from the regulator which results in resolution of complaints reflecting the tip of the iceberg (as many members just do not complain).

The above framework has material implications on the value-for-money of the private retirement arrangements in South Africa. Unfortunately, regulatory action currently seems to focus on the easy cases (eg. massive fraud; fund collapses, etc.). The less visible, but potentially far more devastating losses, pass below the radar.

The following are recently confirmed as occurring:

- Improper actuarial valuations of surpluses, used to encourage the transfer of DB funds to DC funds, with employers attempting to illegally remove surplus funds it had no right to. The conversion to DC arrangements, certainly as they occurred in the past, involved significant and hidden reductions in benefits. Very few members would have understood the implications of the arrangements being made. Conflicts of interest between actuarial advisors, brokers and employers all make this possible.
- Non-payment of benefits can be fairly substantial, as many retirement funds have little incentive to pro-actively ensure that members receive the benefits to which they are entitled.
- The calculation of benefits entitlements in the case of DC funds can often be incorrect. Only a few members will ever be able to dispute such calculations.

- Administration companies and brokers are often in a position to distort the value of the fees to which they are entitled.
- Individual annuities are sold on a commission basis, with deliberately complex fee structures. Furthermore, recourse through the Financial Advisors and Intermediary Service Act is almost impossible, except in the most crass cases of poor advice. Consequently, many people have purchased low-value private annuities. The method of selling, linked to this inherent conflict of interest encourages the development of poor performing private annuities.
- When left to themselves, private retirement arrangements have an incentive to provide as little information to their members as possible. Minimum information required for presentation to members would alter fund behaviour as members would now be in a position to make informed decisions.

It is questionable whether the minimal staffing of the Financial Services Board, and those dedicated to regulating retirement funds are sufficient. Thus assertion stems from the sheer size of the industry and its importance (when viewed from a social security perspective).

2.10. SUMMARY OF KEY FINDINGS

2.10.1 Objective 1 – Income protection to prevent poverty where savings will prove inadequate

South Africa provides a targeted and means-tested system of minimum income support to people who will have inadequate savings in retirement. This system is potentially adequate at present but may be improved in the following areas:

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- The means-test approach to targeting could be reviewed in favour of a 'tax clawback' approach through the application of a universal benefit.
- The value of the grant needs to be indexed to some minimum identified package of goods and services required for effective participation in society. This indexation should also ensure that appropriate inflators are applied to annual adjustments in the grant value.

2.10.2 Objective 2 – Income protection to prevent poverty due to death or disability of a breadwinner

For non-contributors to private retirement funds this risk is entirely faced by the relevant families. This protection can only be extended through improved low-income access to retirement arrangements. The current retirement configuration cannot achieve this objective.

2.10.3 Objective 3 – Incentive for participation of breadwinners in retirement arrangements

A tax-based incentive to participate in a retirement fund is the only approach that attempts to meet this objective.

The value of the subsidy is conservatively estimated at R28,5 billion which substantially exceeds the total value of the SOAP (by R9 billion), valued in 2005 at R19,5 billion.

The existing subsidy provided through the tax system (TES) is not clear and its true value is therefore hidden from adequate public scrutiny.

The existing number of contributing retirees amounts to roughly 900 000 people. It is not clear why such a group should receive R28,5 billion in subsidies, when a lesser amount is spent on roughly 2 million beneficiaries of the SOAP.

The idea that tax subsidies in any way encourage increased levels of saving has been discredited internationally and is not recommended as the best mechanism for achieving appropriate levels of participation in contributory earnings-related retirement arrangements.

The adequacy of coverage provided through voluntary private provision is questionable. No serious study has been done on the realised replacement rates, by income group prior to retirement, achieved through existing retirement arrangements. Indications are that there is a substantial decline in incomes. An analysis is provided in **section 2.4.4** which suggests that the industry-wide replacement rate must be around 23,4%. Although a wide distribution can be expected around this value, this is not good and indicates clearly that superficial assessments of coverage based on numbers of contributors cannot be relied upon for evaluating the quality of coverage in the private contributory retirement system in South Africa.

The analysis in **section 4.2** of this chapter questions even the coverage numbers, with the lifetime participation of many employees likely to be inconsistent.

The only reasonable conclusion possible from the information assessed is that this objective is not accomplished. Furthermore, the indications are that a better configuration can be introduced with a lower fiscal impact.

2.10.4 Objective 4 – The system of minimum provision must apply equally to citizens and permanent residents, with the fair treatment of temporary residents

This issue is covered by the Constitution and requires the elaboration and introduction of a positive legislative framework.

2.10.5 Objective 5 – Government interference in voluntary arrangements over-and-above the minimum required protection, in the form of subsidies, should be limited to supporting access for the low-income group impediments to access

Currently this objective is not addressed at all. Subsidies are provided for the discretionary savings of high income groups who would in any case make these savings. The international review confirmed that the tax system should be neutral in respect of discretionary savings as no social objective can be served by subsidising this group.

2.10.6 Objective 6 – The full retirement framework

should, without exception, be subject to adequate regulation, oversight and governance

The adequacy of the existing regulatory framework is questioned in this report.

2.10.7 Objective 7 – Private markets must be regulated to fully empower consumers

Consumers remain disempowered to a great degree by the current framework. Transparency is poor, with the value for money of products on the market deliberately opaque. Recourse in cases of abuse, although it exists, is unlikely to prevent many retirement funds and intermediaries from skimming from large numbers of the public.



CHAPTER THREE - KEY RECOMMENDATIONS



3.1. INTRODUCTION

This chapter provides strategic recommendations on a future framework for the South African system of retirement. These recommendations build on the analyses reflected in chapters 1 and 2.

The outcome of **Chapter 1** was a set of objectives which, in terms of international best practice, seems to be appropriate. **Chapter 2** assessed the extent to which these objectives have been met within the South African context.

The recommendations provided here provide a framework for the envisioned retirement system.

3.2. STRATEGIC FRAMEWORK

This section provides a high-level strategic framework for the achievement of a retirement system in keeping with South Africa's level of development and its need to ensure adequate access to social security, as required by the Constitution.

It is recommended that:

- The State Old Age Pension (SOAP) be reconfigured from a means-tested social assistance programme to a universal non-contributory benefit available to all citizens and qualifying residents. The additional cost to Government of this revised minimum benefit system, estimated at R9 billion (See **Chapter 1, section 7**) will be funded from a retrenchment of the existing Tax Expenditure Subsidy (TES) provided to high-income groups, valued at 28.5 billion (See **Chapter 2, section 2.7.3.4**).
- The existing TES to higher income groups for retirement provision lacks any defensible rationale and should be removed entirely from the system.
- In order to ensure adequate minimum levels of contributory retirement provision, a mandatory contributory system should be introduced. Contributions to this system should be mandated from the age of 25 for all income earners. Contributions should be set at 15% of pre-tax income. If the value is set below this, many contributors will not reach adequate levels of replacement. Contributors will be all taxpayers, i.e. everyone above the tax threshold.
- The final replacement value is influenced by administration charges. Given this, accredited retirement funds that can offer services at or below a statutorily determined cost structure, need to be considered. As in many countries, the private mandatory environment will be made up of large funds, or administrators, who can achieve sufficient economies of scale to meet the target. Funds wishing to be accredited would need to meet specified governance standards. Funds accredited to manage mandatory retirement funds should be required to achieve charge ratios below 15%.
- To further support the mandatory system a Government Sponsored Retirement Fund (GSRF) should be introduced. This should be made the default retirement provider unless an employer opts out. An employer should be permitted to opt out if they participate in an accredited retirement fund. This opt out should only apply to the defined contribution portion of the mandatory tier. (See below).
- Two tiers of mandatory contribution should be considered. The first tier, reflecting 50% of the contribution should go to a pay-as-you-go (PAYG) defined benefit offered via the GSRF.

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- No opt-out should be permitted for employers or individuals in respect of the PAYG portion. This is to prevent the ratio of current members to pensioners from deviating from that for all taxpayers. Furthermore, private arrangements cannot safely offer a PAYG arrangement.
- The PAYG tier should be formula-based, with automatic adjustments in benefits over time if the ratio of contributors to beneficiaries changes.
- The mandatory tier will require that death and disability cover be offered.
- Over-and-above the PAYG mandatory contribution, a defined contribution (DC) benefit should be offered. This should be fully funded, whether through the GSRF or an accredited fund.
- The full mandatory tier should target a replacement rate of 40%, including the SOAP.
- Over-and-above the mandatory contribution people should be free to save in whatever form they prefer. No subsidy of any kind should be provided for these savings.
- Funding for post-retirement medical scheme contributions should be incorporated into the PAYG portion of the mandatory contribution. The reason for incorporating it into the PAYG portion is because the benefits are not earnings-related, and will indemnify contributions toward a designated portion of a Government-established, privately offered set of prescribed minimum benefits (PMBs) that are efficiently costed. The extent of the contribution indemnified needs to depend on the medical scheme contribution record of the individual. For this arrangement to operate effectively, a formal relationship between the South African Revenue Services (SARS), the GSRF and the risk equalization fund (REF) (currently being implemented), will be needed.

- In line with the recommendations relating to ordinary retirement provision, no tax expenditure subsidies (TES) should be provided to “encourage” voluntary savings for post-retirement medical scheme cover.

3.3. SUBSIDY FRAMEWORK

Based on the analysis in **Chapter 2**, there is a clear need to restructure the retirement system subsidy arrangements. Far from increasing them, however, there is a need to reduce these to a level that favours lower-income groups over higher income groups. Certainly no rationale can be found for providing higher subsidies to the highest income groups, as is the case at present.

A revised framework could consider the following:

- The state old age pension (SOAP) should be made universal for all citizens and qualifying residents, with the inefficient means test arrangement removed;
- The progressive nature of the personal income tax system should be regarded as clawing-back a portion of the allocation to higher income groups;
- The TES applicable to private retirement arrangements needs to be wound down, as the only permitted allocation should be the SOAP;
- To ensure maximum participation in the contributory retirement system, participation should be made mandatory, with contributions raised via the tax system;
- This framework should result in an annual R20.3 billion saving, which can be allocated to other high priority government programmes.

3.4 CONSTRUCTION OF THE MANDATORY PILLAR

The structuring of a mandatory pillar for retirement contributions is an essential intervention to ensure adequate levels of earnings-related retirement provision as well as death and disability cover.

The establishment of this pillar requires that retirement fund service providers are available to support mandatory contributions and benefits, offered in both a private and a public system.

Given the fragmented nature of the private retirement system in South Africa, some standardisation is required to ensure that minimum standards are met by any fund operating in the mandatory system.

A GSRF is also proposed to support the mandatory system. Such a fund is ideally placed to offer a DB style PAYG benefit as well as DC benefits. Splitting all mandatory contributions between a DC and DB portion will shift some of the risk faced by individual contributors back into larger risk pools, which are easier to regulate.

However, a PAYG tier is most appropriately offered via a mandatory funding vehicle, such as the proposed GSRF, as this is the best way to ensure effective cross-subsidisation between contributors

and beneficiaries. This tier would not have to be fully funded, as it relies on the establishment of a formula-based balance between contributors and beneficiaries. In addition, as the “risk pool” includes all tax-payers, the fund cannot become insolvent unless the formula is incorrectly specified.

The DC portion of contributions paid to the GSRF should be fully funded.

Mandatory contributions should be deducted via the income tax system. These should be set at a minimum of 15% of income. Where an income-earner has opted for a private retirement arrangement for 7.5% of income, this need not be deducted, provided proof is submitted of payment to an accredited fund.

The recommendation for contributions at 15% from age 25 to 64 is tentative, but based on a quantitative exercise which suggests that the best replacement rates are achieved at this rate. **Table 21** shows the results for four configurations, 24-64, from 25-39 with a break in contributions for five years, from 24-39 with a break in contributions for 10 years, and contributions initiated from age 40 with no break until 64. This last proposal was the recommendation in the Taylor Committee. Among the alternatives, the Taylor Committee recommendation came out with significantly lower replacement rates.

Table 21: Alternative contribution periods and the resulting replacement rates for individuals with 0% and 2% real income growth from the age of 25, with taxation of ROI set at 23.4%

| Real income change pa: | Replacement rate | |
|--------------------------|------------------|-------|
| | 0% | 2% |
| Contribution period | | |
| 25-64 | 43.7% | 30.3% |
| 25-39, 45-64 | 38.1% | 26.7% |
| 25-39, 50-64 | 32.8% | 22.8% |
| 40-64 (Taylor Committee) | 25.7% | 20.5% |
| Administration costs: | | |
| 5% of contribution | | |
| 0.4% of assets | | |

KEY RECOMMENDATIONS

KEY RECOMMENDATIONS

These mandatory contributions can at some point be included in a mandatory social security contribution, raised via the tax system, which can fund key social security benefits including health care and unemployment insurance.

The PAYG tier should incorporate a payment toward post-retirement medical scheme contributions. This benefit, which should include death and disability cover, should be separately managed from the earnings-related retirement benefit.

3.5. GOVERNMENT SPONSORED RETIREMENT FUND

3.5.1 Overview

The proposal for a GSRF arises from the need for institutional intervention to balance the retirement system in favour of social security objectives. The private commercial retirement environment primarily operates with a profit incentive which usually undermines social security objectives. Corrective actions to the retirement framework should not eliminate the private sector, but instead provide a balancing influence, coupled with associated regulatory measures to better empower consumers.

3.5.2 Governance

The GSRF should be operationally independent of Government, but regulated by the Registrar of Pension Funds.

As the fund primarily has a social security function it should report to the Minister of Social Development.

The GSRF should have a board that is appointed by the Minister of Social Development, with the following qualifications:

- Members are appointed in their individual capacity;

- A chairperson should be appointed by the Minister, with a deputy chair elected by the Board;
- Members should have a minimum spread of professional qualifications, including: legal, actuarial, accounting, economics, public finance, and medical;
- Members should have no executive responsibilities and operate entirely as oversight of the executive;
- Members should be appointed for 3-year terms, with a maximum stay of two terms; and with staggered participation;
- Members should be fit-and-proper, in accordance with a set of explicit criteria setting out what fit-and-proper entails; and
- Members should face individual liability where they have acted negligently.

An executive should be appointed by the Board only, given their individual liability, and operate in terms of renewable five-year contracts.

In charge of the executive should be a Chief Executive Officer (CEO) who should have direct operational responsibility for all the operations of the GSRF. The CEO should establish the organisational structure of the fund with the approval of the Board.

The financial arrangements of the GSRF should be provided for in a Money Bill that is distinct from the legislation establishing the fund.

3.5.3 Statutory role

This section provides an illustrative framework on the statutory functions of the GSRF.

The GSRF should have the following functions:

- Responsibility for the establishment and operations of a DB PAYG tier of the retirement system;

- Responsibility for the establishment and operationalisation of a fully funded DC tier of the retirement system, a portion of which may be managed by the GSRF;
- Ability to receive funds allocated by Government to fund the DB and DC benefits offered as prescribed in Government regulations;
- Ability to transfer funds received by the GSRF to private funds where members opt to fund their DC arrangements elsewhere;
- Ability to receive funds from Government in respect of post-retirement medical scheme benefits;
- Responsibility for the management of mandatory death and disability cover as prescribed by Government regulation, which would include cover related to medical scheme contributions;
- Responsibility for the establishment and maintenance of a registry of beneficiaries;
- Responsibility for the establishment of appropriate relationships with the Unemployment Insurance Fund (UIF); SARS; REF; and the Social Security Agency, which shall include the exchange of information, and co-ordination of benefits;
- The management of investments in respect of the funded portion of any benefits;
- Advising the Minister of Social Development on any aspect of retirement provision, social security and legislative changes to any Act governing the operations of the Fund.

3.6. POST-RETIREMENT MEDICAL SCHEME PROTECTION

3.6.1 Overview

The protection of post-retirement medical scheme contributions would represent an important step in improving access to healthcare for key vulnerable groups. As people age their health needs grow. However, incomes decline in retirement. Declining incomes in retirement cause retirees to drop out of the contributory health care environment (medical schemes) at a time where their health needs are greatest. In addition, where a breadwinner dies or becomes disabled without sufficient insurance, whole families can lose access to contributory healthcare services.

Protecting continuity of cover cannot be effectively achieved through private savings vehicles or insurance. Some might get good cover, while others get none. Where a tax break is offered as an incentive for coverage, as with other forms of retirement provision, the benefits are primarily to the advantage of high-income groups. This form of protection is, however, best achieved through the use of social security institutions designed to smooth incomes over time.

3.6.2 Recommended framework

To best eliminate the social security gaps that have arisen in relation to medical scheme cover, it is recommended that a system that integrates a number of social security entities be implemented. The purpose of this integration would be to establish a mechanism allowing individuals to create an entitlement to subsidised post-retirement contributions, based on their years of contributing to a medical scheme. Such an arrangement can be designed as a funded DC arrangement or an unfunded PAYG DB system.

KEY RECOMMENDATIONS

It is recommended that a portion of every medical scheme contribution, referred to here as a post-retirement contribution (PRC), be allocated to the GSRF to fund the post-retirement cover of the contributor, and to fund the death and disability insurance for contribution protection. This contribution to the GSRF would be mandatory for all qualifying medical scheme members.

The PRC would be fixed in value in relation to a costed set of prescribed minimum benefits (PMBs) as determined from time to time in the Medical Schemes Act No.131 of 1998. A structure that will maintain a costed framework for minimum benefits is to be institutionalised via the risk equalization fund (REF) that is soon to be established. The most important explicit parameter for the determination of post-retirement protection is therefore available.

A key question is whether the mandatory PRC is to fund a DC or a DB benefit. The merits of the respective benefits are as follows:

- A DC benefit will not necessarily match the value of the PMBs. It could over- or undershoot the required value for many reasons, including variations in investment performance. As Government policy should only seek to provide minimum protection, a benefit framework that achieves this objective is required; no more and no less is needed.
- A DB benefit, tailored to the PMBs, provides an explicit relationship between contribution and benefit. In a PAYG arrangement this relationship can be specified explicitly, enhancing acceptance of the mandatory contribution.
- A PAYG DB arrangement offers the establishment of a rules-based relationship between medical scheme participation and social security protection in old age. This would permit the removal of the existing late-joiner penalty arrangements, as long-range anti-selection in-

centives are significantly removed. The explicit linkage between contribution and benefit would be less distinct in a DC arrangement, reducing the anti-selection disincentives.

- The PAYG DB framework can easily be supported by the proposed registry information to be established in the REF. The REF will establish a beneficiary database which shall be used to assess social security entitlements in relation to medical scheme coverage. This will include tracking medical scheme participation of individuals through their entire lifetimes. This information can be used to establish entitlements to post-retirement subsidies based on an individual's medical scheme participation.

3.7. SEQUENCING OF REFORM

The recommendations provided in this chapter would require extensive consultation on many aspects of the detail and should be seen as a basis for focused future discussion. Central features of this reform will need to focus from the outset on the establishment of institutions that are able to support and implement the framework. It is possible that initial priority will have to be given to institutions rather than the detail of benefits.

The initial implementation of a mandatory tier to the South African retirement system could therefore require the implementation of the GSRF as a first step. The legislation establishing this fund would also provide the enabling framework for all the social security elements.

The GSRF could initiate activities through operating a voluntary DC arrangement, prior to the establishment of the complete mandatory tier. Once full readiness has been attained, the mandatory system should be implemented. The establishment of the mandatory system should include the post-retirement medical scheme arrangements.

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CONCLUSION



“If successful, the recommended framework will achieve a significant enhancement to the general well-being of the Nation and the realization of key rights entrenched in the Constitution”



CONCLUSION

This discussion document has covered a wide spectrum of strategic policy issues relevant to the restructuring of the South African retirement system. The proposed framework outlines a vision that, if finally accepted by Government, would take many years to implement.

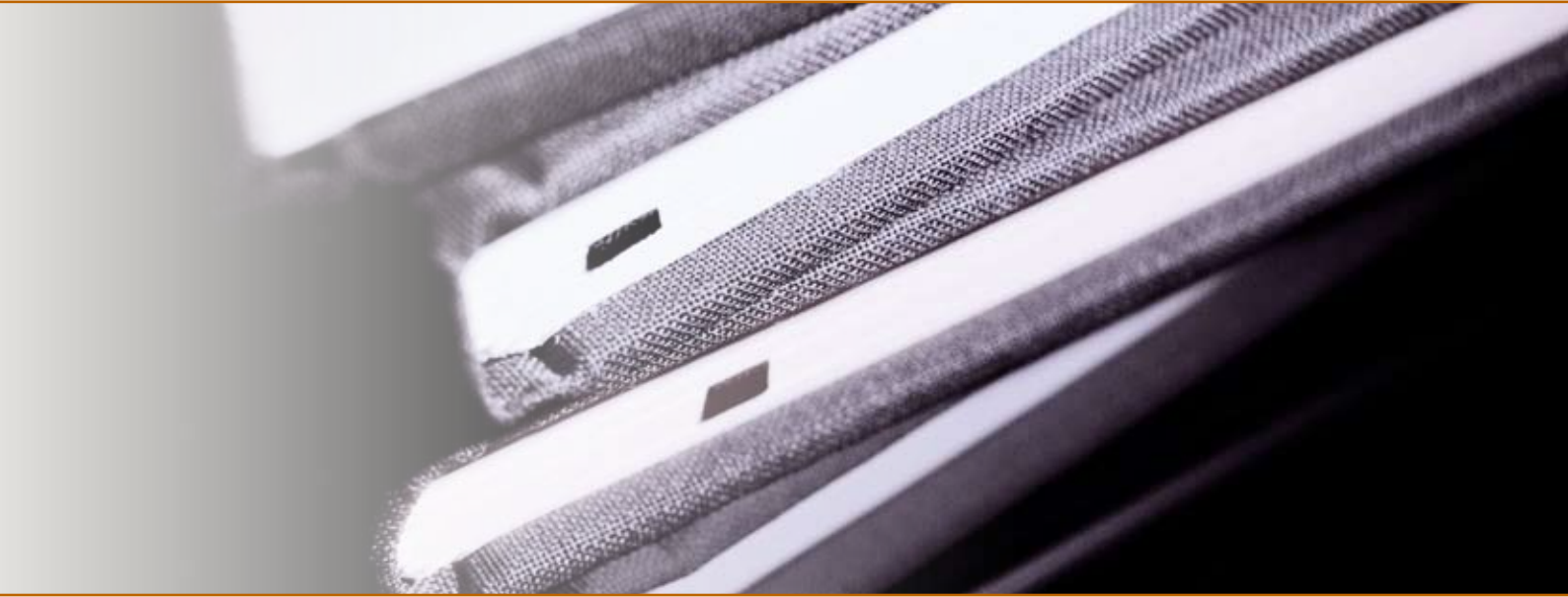
The purpose of outlining the central features of such a system is to facilitate constructive and meaningful debate on strategic policy going forward. The positions outlined here, although not final, represent a clear starting point for future reforms. It should also be clear from the recommendations that systemic reform, which departs substantially from the past, is under consideration. Significant changes are proposed both in respect of social assistance and the contributory retirement system.

If successful the central achievements of such a reform would be: increased access to social assistance; increased access to the contributory retirement system; expansion of coverage for contributory death and disability protection for all taxpayers; improvement in the quality of coverage for both retirement provision and death and disability insurance through reduced costs and increased risk-pooling; and the establishment of an intervention which protects the continuity of medical scheme contributions into retirement and/or where a breadwinner dies or becomes disabled. If successful, the recommended framework will significantly enhance to the general well-being of the Nation and the realisation of key rights entrenched in the Constitution.

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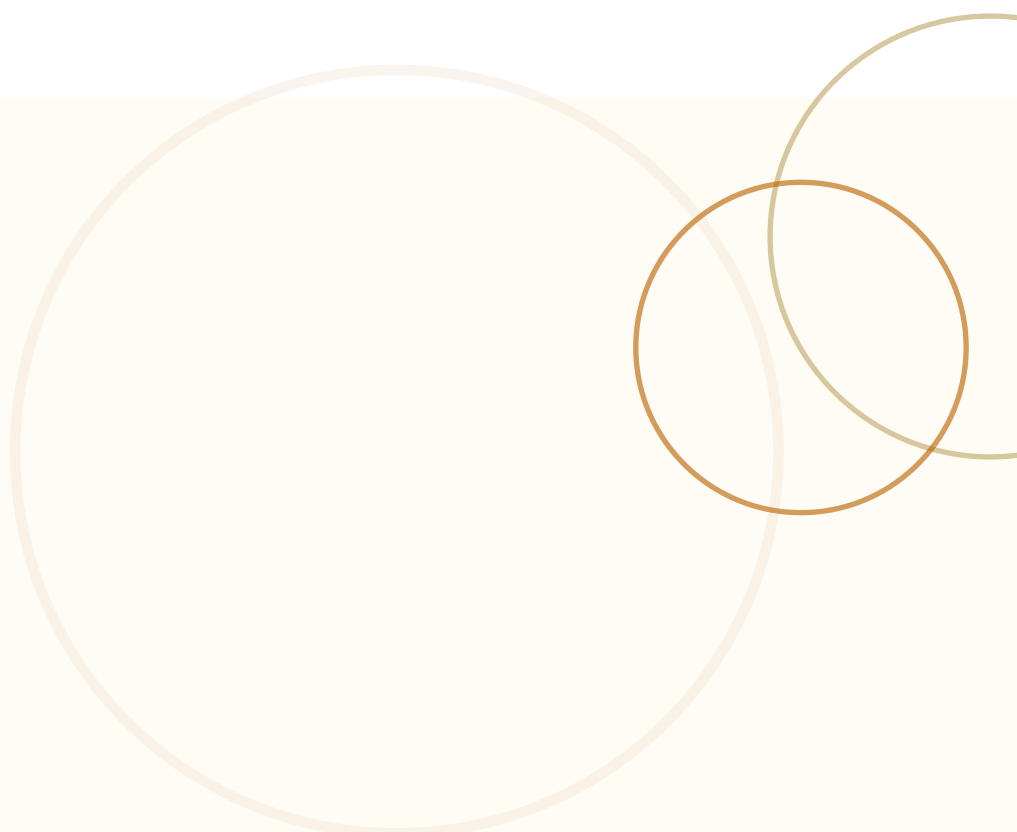
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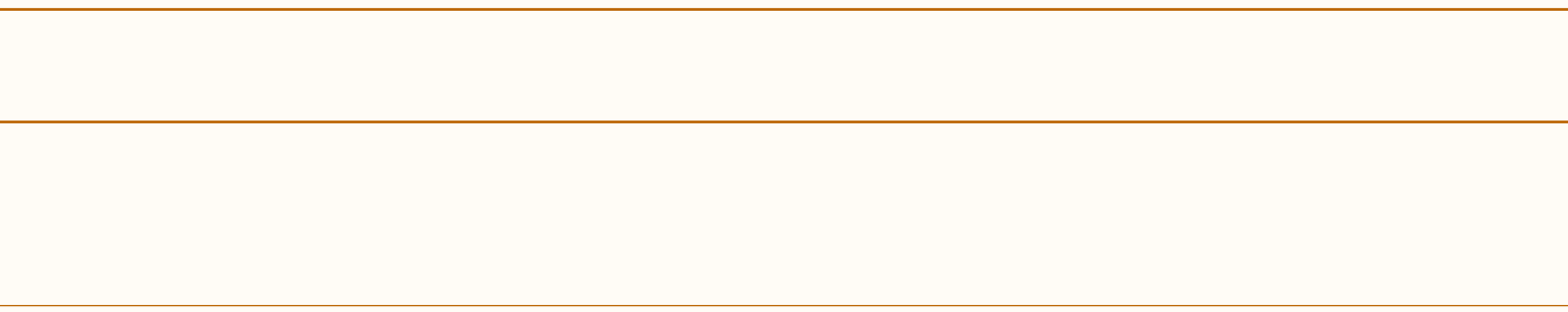
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