JOINT FORUM: RETIREMENT AND SOCIAL SECURITY REFORM

Preservation and Annuitisation Workgroup Report

Please note this is a draft discussion document and is not a mandated position of the Joint Forum.

1. We strongly support compulsory preservation and annuitisation

Preservation and annuitisation play a central role in the overall structure of retirement and social security. Recent research shows there to be significant leakage of savings within the current SA retirement framework. This is probably the greatest weakness of the current system, far greater than the often quoted issues of governance and cost. We therefore strongly support the requirement for compulsory preservation and compulsory annuitisation in respect of funds from compulsory or tax-advantaged contributions. We note further that the proposal for compulsory contributions makes sense only when combined with compulsory preservation.

2. These should be requirements of both the NSSF and private-sector funds

We understand pillars 2 and 3 to both be compulsory, earnings related structures, with one administered by the state (in the form of a National Social Security Fund) and one by the private sector (in the form of private-sector funds). Since what has been proposed for each of these pillars has strong similarities, our views regarding preservation and annuitisation are the same for both, and would therefore apply equally if these were considered as a single pillar. Our comments are focussed on these two pillars, as we see these representing the formal retirement fund system, but take cognisance of the existence of the other pillars where relevant.

We understand pillar 1 to comprise various social grants, including old age, disability and child grants. We strongly believe that pillar 1 should also include benefits in the event of death and unemployment. We do not see pillar 1 as a funded system, and so the concepts of compulsory preservation and compulsory annuitisation are not applicable. Of course, this does not preclude benefits in the form of regular payments (for example the monthly old age, disability and child grants) as well as a regular income for periods of unemployment. In fact, the only lump-sum benefit from pillar 1 might be a nominal death benefit to cover funeral and related expenses at death.

We understand pillar 4 to be voluntary additional savings. As such, we believe that it is inappropriate for there to be any regulatory restrictions on access to such savings, and neither preservation nor annuitisation should be compulsory within this pillar.

3. Preservation and annuitisation are related and require coherent treatment

Preservation is often thought to be a "pre-retirement" event, while annuitisation is often thought to be a "post-retirement" event. We believe however that there needs to be coherent treatment of preservation and annuitisation, given the very grey line that exists between the two. For example, if a member dies at age 35 (pre-retirement) it is annuitisation that should be compulsory and not preservation. Similarly, you would not want members faking “retirement” at age 60 simply because annuitisation benefits are more flexible than preservation benefits.

A coherent treatment of preservation and annuitisation could be stated as follows:

- preservation is compulsory in all circumstances, but
- annuitisation is allowed when the member is no longer able to earn an income, for example on death, permanent disability or the attainment of age 55, and
- annuitisation becomes compulsory on the attainment of age 75.

We note that the above statement allows for the growing phenomenon of "phased retirement" as a result of increased longevity. For example, members might scale down their work when they reach age 50, continue with scaled-down work till age 70, after which they require a retirement income. You can't say at what age the members retired! All you know is that they contributed till age 50, maybe stopped contributing till age 70, and only required a retirement income from age 70. “Preservation” should be a requirement throughout. But “annuitisation” should be an option any time between ages 55 and 75, or on earlier death or permanent disability.

4. Lump sum benefits should be avoided as far as possible

Most members are unlikely to receive adequate financial advice. Without such advice, there is a significant risk that lump-sum benefits will be used unwisely. Where the fund balance exceeds a certain fairly substantial amount, allowing a lump-sum benefit may be more appropriate. However, considering the Government’s aim of social solidarity, a single consistent approach is necessary, and we believe it better to prevent partial lump sums for all than to allow them for all.

We therefore believe that lump sums should be only those purchased for a specific purpose or offered via another pillar. For example, if a member dies, funeral costs should be met by a specific death benefit from pillar 1. If a member is retrenched, unemployment insurance within pillar 1 should meet any temporary income need.

Those funds destined for income-provision should be reserved for income-provision – and annuitised only when the member is no longer able to generate their own income. For example the retrenched member must be forced to preserve, and the surviving children of the member must be forced to annuitise.

We recognise however that traditional life annuities might not be the answer in all cases, and there must be minimums below which annuitisation is not a requirement.

5. Annuities should ideally include some form of inflation protection

It is highly desirable that annuitised amounts and other income benefits should include some form of inflation protection. Many overseas systems aim for pension indexation (in payment or deferment) at a rate equal to national wage inflation, or some rate between wage and consumer inflation. South Africa has high levels of unemployment and a large informal sector. It is therefore considered inappropriate to index with reference to wage inflation. Consumer inflation, or consumer inflation plus some fixed percentage, seems to be the most appropriate benchmark.

Pillar 1 benefits (income and lump sum as relevant) should therefore be indexed to the agreed benchmark and this should be stated specifically.

An element of inflation protection should also be compulsory for annuitised amounts from pillars 2 and 3. The aim here should be to protect incomes from inflation erosion without unduly constraining investment returns and hence long term income levels. A "first slice" approach might therefore make sense. For example, where funds from the NSSF are annuitised, strict inflation-linking could be a requirement, and might well be offered in the form of NSSF annuities. The same requirement would apply to the relevant amounts where a member has opted-out of the NSSF, assuming such opt-out were to be allowed.

In order to enable far more inflation linking than is currently provided within the retirement fund and annuity market, a much greater range of inflation-linked securities would be necessary to provide some element of asset matching to inflation-linked liabilities. While the private sector could assist in creating more of such assets, Government is urged to issue more inflation linked assets, including very long duration assets. A variety of coupons will also be appreciated.

6. Annuities should be "for life" but only where this is appropriate

We have said above that preservation should be compulsory but that annuitisation should be allowed on death, permanent disability or the attainment of age 55.

Where annuitisation is allowed as a result of old age, an annuity "for life" makes sense for a "first slice" of income. For example, where funds from the NSSF are annuitised, an annuity "for life" could be a requirement, and might well be offered in the form of an NSSF annuity. The same requirement would apply to the relevant amounts where a member has opted-out of the NSSF, assuming such opt-out were to be allowed. Given the complexity of modern-day partnerships and the resulting administrative difficulties, a spouse's pension is not recommended. However, we feel that such annuities should have a minimum term of say 10 years in order to deal with deaths shortly after annuitisation. The remaining income benefits can be paid either to a surviving partner, or to a family guardian of the member's choice.

Where annuitisation is allowed is a result of death, an annuity "for life" does not make sense. In these cases the neediest of dependents are typically children, and their income needs are greatest while still at school. Even the income needs of a surviving partner are typically greater in the years shortly after the member's death than later in life. The surviving partner may have a low life expectancy, or may later be eligible for an old-age income of his or her own. In these cases, instead of an annuity "for life", we support a term annuity of say 10 years. Income benefits can be paid either to a surviving partner or to a family guardian, with the express purpose of caring first for any children and then for the needs of the surviving partner.

Annuitisation as a result of permanent disability poses unique challenges. On the one hand, we would not want a system to encourage fake disabilities for the sake of early annuitisation. On the other hand, annuitisation for the genuinely disabled should allow for shorter life expectancies as a result of disability. For example, a member might be sick with AIDS and unable to earn an income as a result of the severity of the sickness. Such a member should be allowed to annuitise, but should not be required to annuitise "for life", given that "life" rates would not necessarily take the sickness into account. A term annuity of say 10 years might again be the solution, with benefits payable to a surviving partner or family guardian after death.

7. The resulting rules should to be simple and easy to understand

Given all of the above, the following simple rules might apply to the NSSF. (The same rules would apply to the relevant amounts where a member has opted-out of the NSSF, assuming such opt-out were to be allowed.)

- Fund credits within the National Social Security Fund can be used to purchase an inflation-linked annuity any time after age 55. Where fund credits have not yet been used by age 75, the purchase happens automatically at that age.
- The annuity is "for life" but with a guaranteed period of 10 years. Remaining payments are paid to your partner or to a family guardian of your choice.
- If you were to die before using your fund credits, they will automatically be used to purchase an inflation-linked annuity for a fixed period of 10 years, payable to your partner or a family guardian of your choice.
- Fund credits are "topped up" on death, by an age-related amount. Members dying at younger ages receive larger top-ups, given that they are likely to have smaller fund credits and greater family needs.
- If you were to become permanently disabled before using your fund credits, they can be used to purchase an inflation-linked annuity for a fixed period of 10 years. If you were to die during that period, the remaining payments will be paid to your partner or to a family guardian of your choice.

Equally, the following simple rules might apply to private-sector funds:

- Fund credits within your private-sector fund can be used to purchase an annuity any time after age 55. Where fund credits have not yet been used by age 75, the purchase happens automatically at that age.
- The annuity need not be "for life" given that your NSSF annuity is "for life". Any remaining payments or remaining balances are paid to your partner or to your estate.
- If you were to die before using your fund credits, they will automatically be used to purchase an annuity payable to your partner or to your estate.
- Fund credits may be "topped up" on death, by an age- and gender-related amount. Members dying at younger ages may receive larger top-ups, given that they are likely to have smaller fund credits and greater family needs.
- If you were to become permanently disabled before using your fund credits, they can be used to purchase an annuity. If you were to die at a later date, any remaining payments will be paid to your partner or to your estate.

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