

# **Strengthening retirement savings**

**An overview of proposals  
announced in the 2012  
Budget**

14 May 2014

National Treasury

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## ■ Introduction

*“A series of discussion papers will be released this year on promoting household savings and reforming the retirement industry.....Among the issues are improved governance over pension funds... and ways to improve preservation of retirement fund assets and to ensure higher levels of income in retirement.*

*– Minister of Finance, 2012 Budget Speech*

This document provides an overview of government’s proposals to promote retirement savings, as announced by the Minister of Finance during the 2012 Budget speech. The need for such reforms is evident: most South Africans do not save adequately for retirement and only about half of the country’s workers belong to a retirement fund.

*Reforms proposed to encourage South Africans to save for retirement*

Government is committed to increasing the financial security of all citizens. To realise this objective, wide-ranging proposals to reform social security and retirement fund arrangements are under consideration. The goal is a fair and sustainable social security system, supported by a mandatory statutory fund that provides pension, life insurance and disability benefits. Within this framework, government will encourage additional savings in approved retirement funds for those earning above a specified threshold.

This overview document focuses on complementary proposals to improve the retirement funds industry while the broader reform process is under way. The 2012 *Budget Review* identified four principal concerns with retirement and other investment products:

*Proposals address lifetime savings, preservation levels, high fees and annuitisation*

- Inadequate lifetime savings
- Low levels of preservation and portability
- High fees and charges
- Low levels of annuitisation.

This document presents an overview of proposals addressing these matters, centred on:

- Reducing the costs of retirement products
- Reforming the annuities market
- Requiring preservation and portability
- A uniform approach to the tax treatment of retirement fund contributions
- Improving fund governance and the role of trustees
- Tax incentives to promote retirement and other investment products.

Over the course of 2012, the National Treasury will release a series of technical discussion papers elaborating on these matters. A separate process is under way to improve financial sector regulation, moving towards a twin peaks model with standalone regulators for prudential and market conduct. Prudential supervision will ensure that retirement funds are soundly managed; market conduct supervision will make cost

structures more transparent, and protect policyholders from unfair practices and charges.<sup>1</sup>

#### Box 1: Technical discussion papers to be released for consultation during 2012

A. *Retirement fund costs* – Reviews the costs of retirement funds and measures proposed to reduce them. Paper due to be released by October 2012.

B. *Providing a retirement income* – Reviews retirement income markets and measures to ensure that cost-effective, standardised and easily accessible products are available to the public. Paper due to be released by June 2012.

C. *Preservation, portability and uniform access to retirement savings* – Gives consideration to phasing in preservation on job changes and divorce settlement orders, and harmonising annuitisation requirements. The aim is to strengthen retirement provisioning, long-term savings and fund governance. Paper due to be released by June 2012.

D. *Savings and fiscal incentives* – Discusses how short- to medium-term savings can be enhanced, and dependency on excessive credit reduced, through tax-preferred individual savings and investment accounts. It also discusses the design of incentives to encourage savings in lower-income households. Paper due to be released by August 2012.

E. *Uniform retirement contribution model* – Proposes harmonising tax treatment for contributions to retirement funds to simplify the tax regime around retirement fund contributions. Paper due to be released by August 2012.

*Reforms will protect the vested rights of pensioners and pension fund members*

Government's proposals take into account the increased prudential risks to retirement funds arising from the global financial crisis, as well as the need to address industry shortcomings, product design flaws and inappropriate market conduct. Relevant proposals will be designed to protect vested rights. Current pensioners or those who are about to retire soon will not be adversely affected by the transition.

This overview document opens a public consultation process with trade unions, employers, retirement funds and the broader public to strengthen the retirement system for all South Africans. It will be followed by the technical discussion papers noted in the box above.

## ■ Background

### Household savings and retirement

*South Africa has one of the world's lowest household savings rates*

Retirement savings constitute nearly 60 per cent of South African household savings. Yet the household savings rate, net of depreciation, has fallen steadily over time.

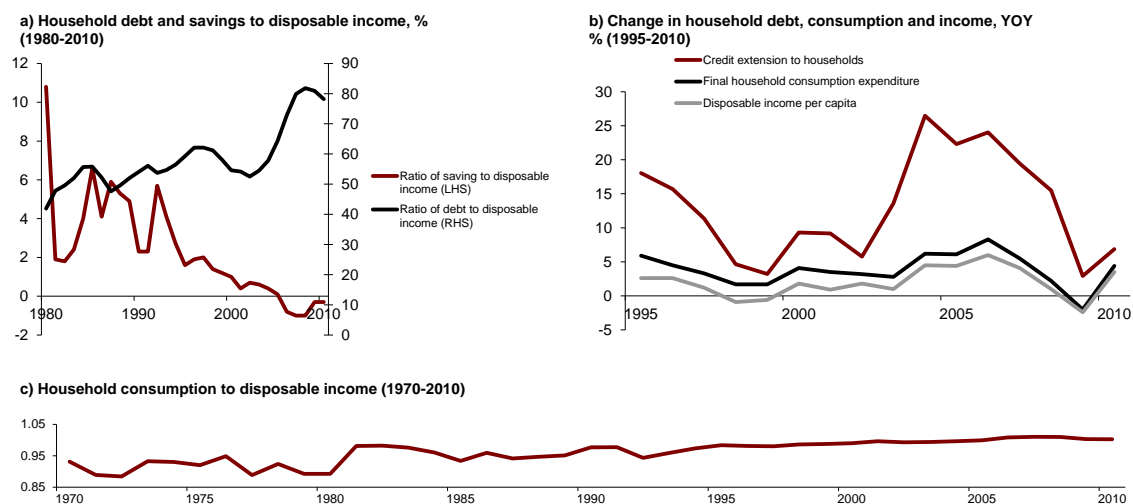
Low household savings reduce the ability of individuals to withstand sudden changes in income or prices, and to maintain their prior levels of consumption in retirement. In the long term, lower savings lead to lower growth and higher taxes, as taxpayers fund those who do not provide sufficiently for their retirement.

Several structural factors explain the decline in South Africa's household savings rates. One important factor is increased access to credit since the late 1990s – primarily secured credit to finance house purchases, as well as unsecured credit. While irresponsible borrowing

<sup>11</sup> See *A safer financial sector to serve South Africa better*, National Treasury policy document, 2011.

and lending is a concern, credit extended and used responsibly has the potential to increase economic opportunity, income and welfare. Growth in credit extension has contributed to increased household consumption in recent years, as shown in Figure 1.

**Figure 1: Household debt, consumption expenditure and disposable income per capita**



Source: South African Reserve Bank

Government seeks to broaden financial inclusion – expanding formal banking and credit systems to previously excluded households – and there is evidence of progress in this area. More lower-income households have access to formal savings instruments than ever before, yet their ability to increase savings through formal channels is likely to be limited in the short term. In 2007, estimated savings outside the formal financial sector (“the grey market”) amounted to R33 billion, mostly in stokvels. A recent survey estimated the value of savings in stokvels at R44 billion.<sup>2</sup>

*There has been progress in expanding access to formal banking and credit systems, but low-income households have limited ability to increase their savings*

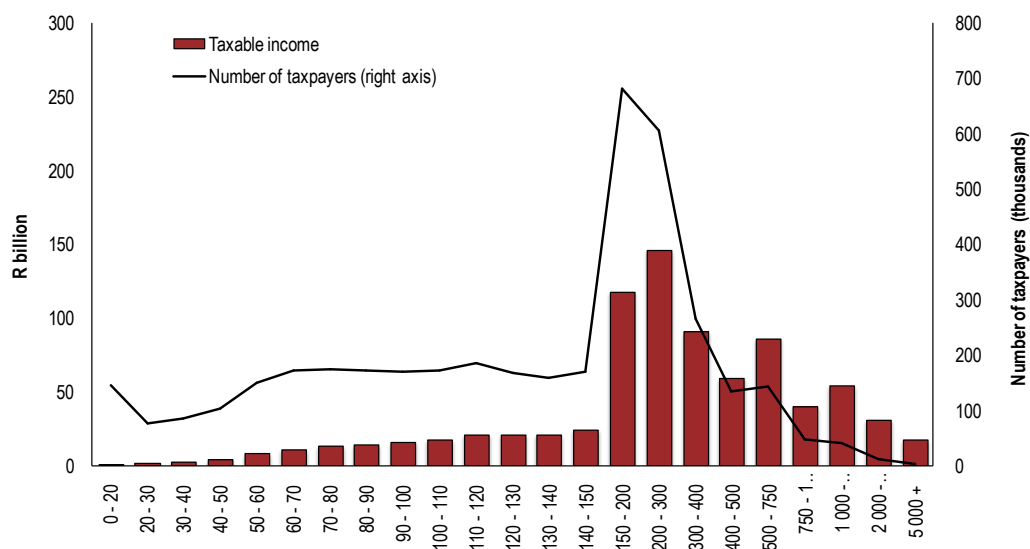
Low-income households saving through the formal sector tend to use low-cost bank accounts (such as Mzansi accounts) and savings products that provide liquidity. Some low-income households also save through retirement funds, particularly provident funds, although their rates of preservation are very low.

Higher-income households generally use a wider variety of formal channels, including life insurance policies, retirement annuities, pension and provident funds, residential housing and collective investment schemes. Changing the incentives that drive savings decisions among middle-income households will encourage additional savings or change its composition. The demand for formal savings among high-income households, however, is likely to be relatively stable. Many of these households will presumably have already allocated their savings and investments on the basis of yield or tax optimisation.

<sup>2</sup>African Response Survey, 2011, *Stokvels are here to stay*, <http://www.africanresponse.co.za/PressReleases/2011stokvel.aspx>

Figure 2 shows the distribution of income by South African taxpayers. Households earning between R150 000 and R400 000 per year accounted for more than 44 per cent of taxable income in 2010. A more effective retirement funds industry, alongside additional incentives under consideration, is likely to increase household savings.

**Figure 2: Taxable income and number of taxpayers by taxable income bracket, 2010**



Source: South African Revenue Service

### The retirement landscape

*The retirement industry has high coverage, high contribution rates and high assets under management*

In many ways, South Africa’s retirement system is successful for employed individuals earning above the income tax threshold. Yet more than half of the formally employed workforce falls below this level, and their degree of retirement coverage depends on the industry in which they work and its degree of unionisation. Although there are significant cross-subsidies within most funds, there are missed opportunities for risk pooling between funds.

Even though the system is quasi-voluntary,<sup>3</sup> coverage of the existing industry is very high by international standards for workers earning above the tax threshold. Contribution rates are also high, and the system provides millions of South Africans with substantial risk benefits that protect their dependants in the case of premature death. Total assets under management make South Africa’s retirement funds industry one of the world’s largest relative to gross domestic product.

Several factors contribute to the size of the industry. Government gives workers substantial tax incentives to contribute to retirement funds (about R17 billion in 2009 on contribution tax relief alone); it is easy to participate in the system because most workers have to make few direct

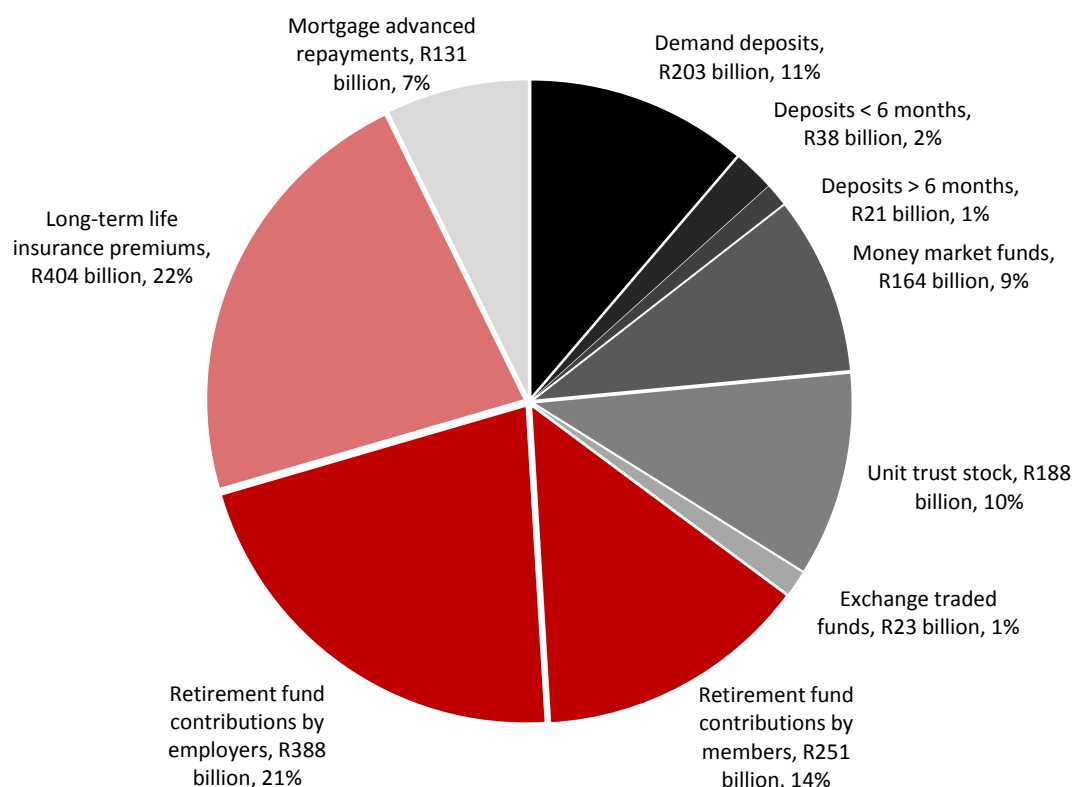
<sup>3</sup> While employers are not required to make retirement provision for their workers, if they do set up a scheme, employees must join as a condition of employment.

decisions; and many funds, especially those where employers make co-payments or bear some of the administration costs, are the most cost-effective way for workers to save.

As a result, retirement funds, including retirement annuities, are the destination of more than half of household savings, as shown below.<sup>4</sup>

*Most household savings flow to retirement funds*

**Figure 3: Nominal savings flows to various asset classes attributed to households, 1999-2010 R billions**



Source: Association for Savings and Investment South Africa, South African Reserve Bank, JSE

**Table 1: Condensed balance sheet of households, 2003-2010**

| R billion  | 2003         | 2004         | 2005         | 2006         | 2007         | 2008         | 2009         | 2010         |
|--|--------------|--------------|--------------|--------------|--------------|--------------|--------------|--------------|
| Non-financial assets                             | 796          | 1 043        | 1 256        | 1 482        | 1 723        | 1 790        | 1 900        | 1 965        |
| Assets with monetary institutions                | 285          | 314          | 352          | 400          | 463          | 546          | 563          | 577          |
| Interest in pension funds and long-term insurers | 1 014        | 1 214        | 1 410        | 1 762        | 1 969        | 1 927        | 2 126        | 2 406        |
| Other financial assets                           | 624          | 737          | 978          | 1 239        | 1 427        | 1 151        | 1 398        | 1 622        |
| <b>Total household assets</b>                    | <b>2 719</b> | <b>3 308</b> | <b>3 996</b> | <b>4 883</b> | <b>5 582</b> | <b>5 414</b> | <b>5 987</b> | <b>6 570</b> |
| Mortgage advances                                | 235          | 307          | 395          | 517          | 658          | 731          | 752          | 781          |
| Other debt                                       | 216          | 250          | 302          | 356          | 413          | 426          | 431          | 476          |
| <b>Net wealth</b>                                | <b>2 268</b> | <b>2 751</b> | <b>3 299</b> | <b>4 010</b> | <b>4 511</b> | <b>4 257</b> | <b>4 804</b> | <b>5 313</b> |

Source: South African Reserve Bank

<sup>4</sup> We are assuming the retirement savings are made up of employee and employer contributions to retirement funds, as well as long-term insurance premiums.

*Complexity and fragmentation of retirement funds industry adds significantly to cost*

South Africa’s retirement funds landscape is complex. Currently there are more than 2 700 funds, and this fragmentation adds significantly to cost.

The Income Tax Act (1962, as amended) defines four different tax dispensations for retirement funds (pension funds, provident funds, preservation funds and retirement annuity funds). The Pension Funds Act (1956, as amended) makes a distinction between funds set up by a commercial sponsor and run for profit (such as retirement annuity funds, umbrella funds and preservation funds) and not-for-profit funds, which may be set up by standalone employers, or by bargaining councils, unions or industry associations for their members. Funds also have different benefit structures: they may be defined benefit, defined contribution or hybrid structures. Table 2 shows the spread of fund assets under management.

**Table 2: Retirement fund assets under management by type, 2011**

| R billion   | Not for-profit | For-profit employer-based | Individual | Total        |
|---|----------------|---------------------------|------------|--------------|
| Public funds (mainly Government Employees Pension Fund) | 982            |                           |            | 982          |
| Defined benefit pension and provident funds             | 343            | 4                         | 2          | 349          |
| Defined contribution pension and provident funds        | 549            | 103                       | 72         | 724          |
| Retirement annuity funds                                |                |                           | 264        | 264          |
| <b>Total</b>  | <b>1 874</b>   | <b>107</b>                | <b>338</b> | <b>2 319</b> |

Source: Financial Services Board, National Treasury

*Low preservation rates mean that few South Africans can maintain pre-retirement consumption when they stop working*

Despite high participation rates, high contribution rates and significant assets under management, only about 10 per cent of South Africans are able to maintain their pre-retirement level of consumption after they stop working – primarily because preservation rates are low. In recent years, the aggregate rand value of flows out of retirement funds – both pre- and post-retirement – appears to have been greater than total new contributions. The overall appreciation in the value of fund assets has largely been a consequence of the general rise in asset prices.

There are several reasons for low levels of preservation. Before they retire, many workers, especially younger and lower-paid employees, withdraw their entire retirement fund balance when they leave an employer. Despite recent changes in the way these withdrawals are taxed to incentivise preservation, this trend has continued.

*Charges in the industry appear high*

The South African retirement industry appears to have a relatively high cost structure with high fees, especially for retirement annuities. Over many years, annual charges on investments can significantly erode benefits, leading to much lower replacement rates than anticipated.

The consequences of low retirement income are serious: in addition to increasing the burden on public finances, it increases the financial vulnerability of the elderly population, leaving many dependent on family for support. This in turn lowers the ability of many young families to save for their own future.



In addition, the system stops protecting most workers after retirement. Members of provident funds can withdraw all of their accumulated benefits in cash, which is often used quickly. Members of pension funds and holders of retirement annuities are required to annuitise two-thirds of their assets when they retire. Many purchase living annuities with their retirement funds, rather than conventional annuities – which are the only products that protect them against outliving their assets – and spend their assets too rapidly or make inappropriate investment decisions. This increases the risk of poverty in old age.

*The retirement system stops protecting most workers after they retire*

## ■ Strengthening retirement savings

Government is proposing several incremental steps to strengthen retirement funding, guided by the following principles:

- Enhancing protections for individual savers, ensuring that their retirement assets are invested in their best interests, and that such protection is of a higher standard than required by consumers of other goods and services.
- Improving efficiency and good governance through consolidation of private-sector retirement funds.
- Encouraging the use of standardised products, promoting competition to benefit lower- and middle-income households.
- Ensuring that changes are consistent with broader social security reform and government objectives.
- Addressing any gaps exposed by the global financial crisis, promoting financial inclusion and stability, and encouraging prudential activity that improves market conduct.

## Reducing retirement fund costs

Although the South African retirement industry is successful in many ways, high costs relative to international benchmarks are a concern. A high cost structure erodes retirement benefits, reduces saving returns and discourages participation in the voluntary system. Over the long term, high costs may threaten the industry's structure.

*'High costs in savings products undermine the national objective of getting our people to save more.'*  
– Minister of Finance, 2012 Budget speech

Annual charges have a particularly negative effect on long-term savings: while a 1 per cent once-off fee is manageable, that same fee levied annually over 40 years will substantially reduce savings.

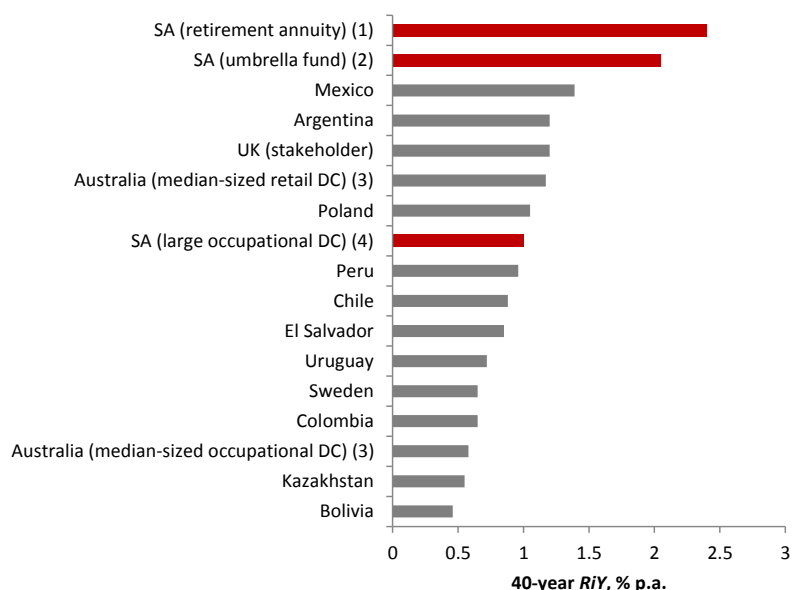
International comparisons need to be conducted with care because retirement institutions around the world change over time and differ in the functions they perform, in their level of maturity and in size, all of which affect cost. One useful comparative tool in assessing cost differences is the reduction in yield (RiY) method, which measures the extent to which charges reduce the annual rate of return on an individual's holding in a fund. RiY is a forward-looking measure, and is accurate only to the extent that the assumptions underlying its calculation are reasonable.

South African umbrella funds and retirement annuities appear much more costly than their international equivalents

Figure 4 shows the 40-year RiY of some South African retirement institutions of different types relative to selected peer countries. While large South African occupational defined contribution funds appear slightly cheaper than the most expensive mandatory retirement systems elsewhere, umbrella funds and retirement annuities appear to be more expensive than their retail equivalents in some other countries.

Charge ratios are significant for retirement annuities, both new and old-generation, and preservation funds (only new-generation retirement annuities are shown in the figure). Although the charge ratios for not-for-profit retirement funds look reasonable, these figures are calculated for larger funds, and the spread of values is large.

**Figure 4: 40-year RiY for selected international retirement systems**



Source: Whitehouse (2000) unless otherwise indicated. Figures refer to mandatory national retirement systems, unless otherwise indicated.

1. Treasury analysis, average of three new-generation retirement annuity providers.
2. Gluckman & Esterhuyzen (2011), Davies (2010), figure measures RiY over the average remaining career of current members, excludes guarantee charges and some low-income workers.
3. Bateman and Mitchell (2004), figures show costs rather than charges; retail defined contribution fund figure may therefore exclude costs of providing financial advice, and profit. Some external fund management costs may also be excluded.
4. Davies (2010) and Gluckman and Esterhuyzen (2011); assumes stable membership and assets per member.

Costs on umbrella funds deserve special attention. These funds have charge ratios that lie between retirement annuities and large standalone funds, although the estimates presented above may be low given the effect of high guarantee charges on underlying investment portfolios. Costs on umbrella funds may fall as the sector matures.

The establishment of a market conduct supervisor is expected to improve transparency, making the retirement industry more competitive and lowering its cost structure.

The National Treasury has reviewed existing work on retirement fund costs. The results of this review will be published in a forthcoming discussion paper. In summary, the review notes that:

*Forthcoming paper presents extensive review of retirement fund costs*

- South Africa has relied almost entirely on market mechanisms to design products, charging structures and fee levels.
- Many retirement products have multiple layers of charges, such as administration and investment management charges, and brokerage, advisor and performance fees, making comparisons across products and channels difficult. Costs of investment management in particular are high.
- The extent of product differentiation may inhibit competition.
- Passive investment management, which is significantly cheaper and not demonstrably inferior to active management over the long term, is under-utilised in South Africa.
- Distribution channels may encourage conflicts of interest between financial advisors and their clients in wholesale and retail markets.

Government is discussing these issues with the industry to help shape policy proposals in the near future. While the issues are complex, options under discussion include:

*Government is working with the industry to find the best way to reduce costs*

- Standardising retirement products to increase competition on the basis of price rather than product design.
- Exploring exemption from the Financial Advisory and Intermediary Services Act (2002) requirements for certain standardised products.
- Mandating charging structures to prevent price discrimination against small firms or employers with lower-paid workers.
- Harmonising disclosure requirements across different products to facilitate comparison and competition.
- Finding ways to encourage a greater use of passive investment management, particularly in the retail sector.
- Limiting the inappropriate use of guaranteed and smoothed bonus funds in retirement funds.
- Discouraging direct payments from providers to intermediaries, especially in the group market.
- Ensuring that trustees, particularly of umbrella and retirement annuity funds, are aware of their responsibilities to members.
- Preventing cross-subsidisation of services to give consumers sufficient price information to make informed choices.

## Reforming the annuities market

*Most defined contribution funds leave members to the retail market when they retire*

The current system guards policyholders when they contribute, but the quality of protection mechanisms declines when members retire. Most defined contribution funds, after automating the savings and investment choices of members over their working lives, leave them to the retail market when they retire.

Members of pension funds and holders of retirement annuities are required to purchase either a living annuity or a conventional life annuity with two-thirds of their accumulated balance. Table 3 outlines the features of these products. Most retirees purchase living annuities, which require complex choices. Many draw down their assets too quickly and invest them in high-risk funds, while others bear the risk of outliving their savings and of poor asset returns.

If members of retirement funds are to be required to annuitise their retirement assets, the annuity market must be structured in a way that encourages members to make good choices.

*A retail bond-based living annuity product is being developed*

A living annuity with an underlying investment in South African retail bonds is being developed to provide an additional simple, low-cost product to meet retirement income needs.

**Table 3: Compulsory annuity products for purchase by members of pension funds and retirement annuity holders upon retirement**

| Product                          | Description  | Features   |
|----------------------------------|--|--|
| <b>Conventional life annuity</b> | Pays an income to individuals until they die, pooling longevity risk across individuals. | Insurer uses its own capital to guarantee the income in the case of mismatches between its assets and liabilities and unanticipated fluctuations in mortality.                               |
| <b>Living annuity</b>            | A phased withdrawal savings account with no longevity risk protection.                   | Individuals must withdraw between 2.5% and 17.5% <sup>5</sup> of the account each year. A wide range of investments is possible. Individual exposure to investment risks may be substantial. |

However, more needs to be done. The forthcoming paper on providing a retirement income includes a review of the annuities market and identifies the following concerns:

- Conventional annuities are the only products available that offer individuals protection against outliving their assets, but they may not offer lower-income households value for money.
- Living annuities – tax-protected savings accounts in which all investment risk is borne by the member, and which offer no protection against outliving their assets – expose many retirees to longevity and investment risk, particularly in late old age.
- Charges, especially in living annuities, are too high.

<sup>5</sup> Proposals intend to reduce the minimum 2.5 per cent withdrawal rate to 0 per cent.

Options being explored with the retirement industry include developing standardised products into which retirement funds can automatically place members when they retire, without requiring financial advice. These products will have to meet design, access and cost conditions. Another option is to allow funds to default members into new types of annuity products that share risks between providers and members, making annuity provision more cost effective and attractive. Higher-income retirees will continue to make their own choices about additional retirement savings.

*Standardised products under consideration will have to meet cost, design and access conditions*

### **Preservation and portability**

Despite high participation and contribution rates, most South Africans reach retirement financially unprepared. Only about 10 per cent of South Africans are able to maintain their pre-retirement level of consumption after retirement, largely because of a lack of preservation of retirement fund assets when members leave their jobs.

Government proposes to phase in, over time, a preservation requirement. When employees change jobs, their balances can remain in their employer's fund, or be transferred to a preservation fund or to their new employer's fund, rather than be withdrawn in cash. The proposal to preserve may be partially waived to allow those who are unemployed and have exhausted their Unemployment Insurance Fund benefits to access a maximum of one-third of their accumulated funds. Access will also be allowed in cases of demonstrated medical need.

*Proposal to phase in a preservation requirement aims to help improve financial security in retirement*

This measure will be phased in over a number of years, following thorough consultation. Protection will be given to vested rights to prevent any short-term disruption to retirement savings, and to minimise the impact on current workers who may view their retirement savings as precautionary or medium-term consumption smoothing.<sup>6</sup>

A forthcoming discussion document will detail these proposals.

### **Harmonising retirement fund taxation**

To simplify the retirement system, government proposes a uniform retirement contribution model, under which all contributions to retirement funds – including annuities, pension and provident funds – and all benefits from these funds will be subject to the same tax treatment.

*To simplify the retirement system, contributions to and benefits from all retirement funds will be harmonised*

Employer contributions to all types of funds will be included in an employee's remuneration as a fringe benefit, but individuals will be permitted a deduction of up to 22.5 per cent of their income if they are under 45 and 27.5 per cent if they are 45 and above. This will apply to both employer and employee contributions.

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<sup>6</sup> Consumption smoothing refers to the ways that people try to balance saving and spending over their lifetime to achieve an optimal living standard, including after retirement.

To cater for the self-employed and partially self-employed, and to ease administration, the income base upon which this deduction is calculated will be changed to the greater of remuneration and taxable income.

To improve equity in the tax system, and to enable lower-income individuals and those with variable incomes to contribute more, it is proposed that the maximum permitted deduction will be greater than R20 000 and less than R250 000 (R300 000 for those of 45 and above), regardless of income. The higher limits for older workers make allowance for those who did not save earlier in their lives.

*A special arrangement for the defined benefit funds that still exist, including the GEPF, will be made*

A special arrangement will be made for defined benefit funds that still exist, including the Government Employees Pension Fund, to prevent excess contributions regarding current fund surpluses or deficits, or complications caused by ageing schemes, to have negative tax consequences for current members.

These changes are unlikely to affect the tax liabilities of the vast majority of taxpayers. By increasing pension contributions, such liabilities could even be reduced.

*Annuitisation proposals will be phased in and will not affect most low-income fund members nearing retirement*

Harmonising the annuitisation requirements of all retirement funds will help protect members from the risk of outliving their assets. To reduce the consequences of this change for older and lower-income workers, it is proposed that this shift be phased in for the over-50s, with a possible increase in the *de minimus* annuitisation requirement from its current level of R75 000. This change will not affect most low-income retirement fund members who are nearing retirement.

The forthcoming discussion paper on a uniform retirement contribution model will describe this approach in detail.

### **Improving fund governance and the role of trustees**

*'Among the issues is improved governance of pension funds, including more effective interventions to eliminate corruption and fraud.'*

*– Minister of Finance, 2012 Budget speech*

Good governance and trust are the foundation of any sound retirement system. Members contribute in the present to save for the future. They have a right to expect that their funds will be managed prudently, in their best interests and in accordance with the law. Several recent high-profile lapses highlight a broader problem with fund governance that, if unchecked, will damage the trust underpinning the system.

In 2007, the Financial Services Board issued PF Circular 130 on good governance of retirement funds. The circular recommends that trustees put in place a documented code of conduct, an investment statement, a communication strategy for members and a performance appraisal system for trustees. The circular also places an obligation on board members to receive training. The Financial Services Board has launched an online education programme, known as the trustee toolkit, to develop and educate retirement fund trustees. Currently, both PF Circular 130 and the use of the trustee toolkit are voluntary.

The active support of both industry and union leaders to improve governance is welcomed. The industry recognises that practices like surplus stripping (where employers obtain surplus assets from a fund illegally) and bulking (where administrators pool the assets of many

funds to obtain higher deposit rates, but keep the interest for themselves) undermine the entire industry.

Improving fund governance also requires dealing with conflicts of interest. The current system of 50:50 representation requires both employers and workers to take joint responsibility for managing such funds. Under this system, trustees do not represent the constituency that appointed them; rather, whether appointed by employers or unions, trustees must act independently and without fear or favour in exercising their fiduciary duties to promote the interests of all members of the fund. To ensure this is achieved, it could become a statutory requirement that trustees have relevant qualifications and expertise in the management of pension funds, with training completed within a set period after appointment.

*It could become a statutory requirement for trustees to have relevant qualifications and training*

To strengthen fund governance, PF Circular 130 will become legally enforceable by the Registrar of Pension Funds. In line with this approach, government will consider a statutory requirement that trustees be “fit and proper”, with no criminal history. Trustees will be declared prohibited persons by the regulator if they are found to have been involved in past transgressions of good pension fund governance. Government and the industry are also considering professionalising the role of principal officer and are evaluating different methods to strengthen the enforcement of laws.

The discussion paper on preservation, portability and uniform access will set out these proposals in detail.

### **Pension fund investments**

Government reissued Regulation 28 in 2011, which sets out the prudential framework under which retirement funds must invest their assets. The regulation establishes principles by which trustees are required to determine their investment policies, and sets maximum permissible limits for investment by asset class and by issuer to ensure that funds are adequately diversified.

*Under the new Regulation 28, trustees must invest assets only in the best interests of the members of the fund*

Trustees are required to invest assets in the best interests of the members of the fund. In addition, they are now required to consider the environmental and social factors underlying investments. This gives trustees the opportunity, where they deem it in the best interests of their members, to align their investment policies more consistently with national goals, such as contributing to infrastructure development.

### **Pension laws to be extended to all public funds**

Pension fund legislation is not uniform across the retirement industry. Several public-sector funds, including funds from Transnet, Telkom, the Post Office, the Associated Institutions Pension Fund, the Temporary Employees Pension Fund and the Government Employees Pension Fund, are exempt from the provisions of the Pension Funds Act. While most of these funds are defined benefit funds, and the frameworks applying to these funds and defined contribution funds will differ, the same principles of member protection and good governance apply.

*Public-sector funds currently exempt from the Pension Funds Act will be brought under its jurisdiction*

Extending the provisions of the Pension Funds Act to give members of public-sector funds the same protections offered to members of private-sector funds is being considered. Where there are exemptions, they will be transparent and subject to review on a regular basis.

## ■ New tax-free savings instrument

Given that retirement savings are part of household savings, any changes to the regulation of retirement funds must take into account the effect on the savings. Proposals to enhance short- and medium-term savings are under consideration.

The current regulatory framework allows individuals to use their retirement assets to fill short- and medium-term consumption-smoothing needs. Low rates of preservation indicate that this function is important for many people.

*A new savings account, with tax-free interest and capital gains, is proposed to boost household savings*

As preservation of retirement funds is phased in, with some exceptions, such funds will no longer be available for short and medium-term consumption smoothing. Taking this into account, government is considering a tax-preferred savings vehicle to encourage individuals to save for short- and medium-term needs without relying on their retirement funds. Many countries have similar accounts, including the United Kingdom (individual savings account), Canada (registered educational savings plan) and the United States (the Roth Individual Retirement Account).

Individuals will be able to save up to R30 000 per year into this account, with a lifetime limit of R500 000. These caps ensure that the wealthy do not benefit excessively from the incentives on offer. Holdings in the account will be exempt from income and capital gains taxes. A broad variety of assets will be permitted, including bank deposits, shares, RSA retail bonds and collective investment schemes. Changes to the existing tax-free thresholds on interest income are considered as part of this reform, and will be phased in to ensure that existing savers are not prejudiced.

This account will raise the after-tax rate of return on accessible savings, and it is hoped that this will boost the overall savings level and the incidence of saving, especially for middle-income households.

*Additional measures to help low-income earners increase savings are under consideration*

The savings account will not benefit those who fall below the tax threshold. To help low-income earners increase their savings, mechanisms similar to the Fundisa scheme are under consideration. In Fundisa, for every rand that households contribute to a savings account, an additional 25 per cent is contributed from funds provided by the Association for Savings and Investment South Africa and the Department of Education through the National Student Financial Aid Scheme. The co-contribution is capped at R600 per year, although members' contributions to the fund are not capped.

To date, more than 11 000 individuals have participated in Fundisa, mainly from lower-income households. These individuals represent about 17 000 beneficiaries. The programme is small because it has not been actively marketed, due in part to regulatory constraints on



advisors. It also only has a limited amount of money available to fund co-contributions.

Increased funding support to such initiatives is being considered. In the coming year government will also examine the extent to which they should be given exemption from the market conduct regulations governing the sale of other financial products, and under what terms.

The proposed tax-free savings instrument and the Fundisa scheme are reviewed in the forthcoming paper on savings and fiscal incentives.

## **Conclusion**

In line with the broader package of social security reforms and the shift towards a twin peaks model of regulation, government is making a number of proposals to strengthen retirement funding and savings now and in the future.

To address the high rate of leakage out of the retirement system, and to ensure that more workers are financially secure when they reach retirement, government is proposing to phase in preservation of retirement fund balances.

*Proposal to phase in preservation requirement will help to ensure workers' financial security after retirement*

Uniform tax treatment for retirement fund contributions and benefits will simplify the retirement system. Several initiatives to reform the annuities market, lower retirement fund costs and strengthen fund governance are under consideration. Annuitisation requirements for all types of retirement funds will be harmonised. To limit the effect on low-income households, the *de minimus*<sup>7</sup> annuitisation requirement will also be raised in tandem with the reform.

Over time, consideration will be given to bringing public-sector pension funds that are outside the framework of the Pension Funds Act, including the Government Employees Pension Fund, into that regulatory framework.

Under the current tax regime, retirement fund savings are often used for other purposes. Government recognises that households have a range of medium and long-term financial requirements and does not wish to inadvertently raise the cost of such consumption. The introduction of a tax-protected savings account to increase the after-tax rate of return on short- and medium-term savings for mainly middle-income earners is also being considered.

Government is also investigating providing new savings products, for example, RSA Retail bond backed living annuity at a cost lower than those offered by the private sector. The National Treasury welcomes suggestions from the public and the financial sector for suitable new savings products.

*Treasury welcomes suggestions for suitable new savings products*

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<sup>7</sup> The requirement to annuitise assets is currently waived if the rand value of the portfolio is below R75 000.

## ■ Comments by 31 July 2012

Comments on this overview document can be submitted by **31 July 2012**. Further comments will also be invited for each of the technical discussion papers after they are published, and will therefore have later submission dates.

Further consultative meetings will also be convened with trade unions, employers, retirement funds and other interested stakeholders.

Comments to be submitted to:

The Chief Director of Financial Investments and Savings, Olano Makhubela, Private Bag X115, Pretoria, 0001; or per facsimile to (012) 315 5206; or per e-mail to [retirement.reform@treasury.gov.za](mailto:retirement.reform@treasury.gov.za).