National Treasury gets serious about retirement reform

24 May 2012
Gareth Stokes : gareth@fanews.co.za

“A series of discussion papers will be released this year on promoting household savings and reforming the retirement industry. Among the issues is improved governance over pension funds, improved preservation of retirement fund assets, and how to generate higher levels of income in retirement.” This comment was paraphrased from the Minister of Finance’s 2012 Budget Speech. National Treasury has taken the first step toward delivering on his promise with a document titled Strengthening Retirement Savings: An Overview of Proposals Announced in the 2012 Budget, published 14 May. The document expands on the basic concepts raised during the Budget, establishes deadlines for the five technical discussion papers to be released through the course of this year, and invites industry stakeholders to comment on the overview document by 31 July.

Retirement reform has been on the agenda for a number of years. It was first described in broad terms in the *Retirement Fund Reforms* discussion paper (distributed in December 2004) and followed by a February 2007 release titled: *Social Security and Retirement Reform*. Seven years into the process Treasury has made little progress on addressing the critical flaws in the savings regime, identified as inadequate lifetime savings, low levels of preservation and portability, high fees and charges on savings products, and low levels of annuitisation. Both the retirement provisioning challenges and the proposals to address them remain virtually unchanged. But instead of implementing these reforms the industry is bracing for another round of discussion documents, think tanks and strategy sessions.

The long journey to retirement Nirvana

Retirement reforms will be thrashed out in six critical areas. The first – and arguably of greatest concern to the financial services industry – is to **reduce the costs of retirement products**. Treasury’s diagram of 40-year Reduction in Yield (RiY) figures for local retirement funding vehicles versus offshore equivalents confirms the high cost of our savings environment. South Africa’s retirement annuity solutions (based on Treasury analysis of three new-generation retirement annuity providers) top the table with a 40-year RiY of 2.4%. Umbrella funds, which are falsely lauded as “cheap” retirement funding alternatives, come in at 2%. And our “cheapest” solutions – the large occupational defined contribution schemes – are more expensive than similar solutions in Sweden, Uruguay and Chile to name a few!

The stakeholders in government’s crosshairs (where retirement cost cutting is concerned) are asset managers and financial intermediaries. “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,” observes Treasury. “And costs of investment management in particular are high!” Proposed solutions include standardising retirement products, mandating charging structures, limiting the inappropriate use of guaranteed and smoothed bonus funds in retirement funds, and discouraging direct payments from providers to intermediaries, among others. The retirement savings environment will look totally different a decade from today.

Treasury’s second proposal is to **reform the annuities market**. At present retirement fund members and holders of retirement annuities must use two thirds of their accumulated balance to purchase either a conventional or living annuity. “Most retirees purchase living annuities, which require complex choices,” notes Treasury. Common errors include drawing down too much of the capital or selecting funds that are too high risk. One of the solutions in this space – which will address the high costs of living annuities in particular – is to create a low cost living annuity with an underlying investment in South African government bonds.

No lasting solution without preservation

Third on National Treasury’s wish list is to **enforce preservation and introduce portability**. It is no secret that the “lack of preservation of retirement fund assets when members leave their jobs” contributes to the poor state of retirement provisioning. The envisaged solution is to phase in mandatory preservation over a number

of years. Accumulated balances will have to remain invested in the existing employer fund, or transferred either to a new employer or preservation fund. Allowance will be made for the unemployed to access a maximum of one third of the fund (assuming their Unemployment Insurance Fund benefits are exhausted) while withdrawals will also be allowed in cases of demonstrated medical need.

Proposal number four is to implement **a uniform approach to the tax treatment of retirement fund contributions**. Treasury observes: "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." This proposal has already been hinted at in the 2012 Budget… Individual taxpayers will eventually be permitted a deduction of up to 22.5% of their income if they are under 45, and 27.5% otherwise. In its current form this will result in allowable deductions of between R20 000 and R250 000 per annum (or R350 000 for over-45s).

Improving fund governance and the role of trustees features as the fifth proposal in the discussion document. This is premised on the rights of members "to expect that their funds will be managed prudently, in their best interests and in accordance with the law!" The basis of this "good governance" is encapsulated in the Financial Services Board's PF Circular 130 that circulated in 2007. And finally, the sixth proposal is for **tax incentives to promote retirement and other investment products**. "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," notes the document.

An accelerated consultation process

Stakeholders in the financial services space will have to brace for an accelerated consultation process. Treasury has promised two discussion documents in June, two in August and one in October this year. These documents – combined with the broad package of social security reforms and the shift towards a twin peaks model of financial market regulation – will outline how government intends to strengthen retirement funding and savings going forward.