Legal update

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Legal Update – Budget Update on Retirement Reforms

Introduction

Following the 2014 Budget Speech, National Treasury released a document titled "2014 Budget update on retirement reforms" on 14 March 2014. This paper is a continuation of the 2013 paper and discusses the retirement reform process first announced by the Minister of Finance in 2012. The paper recaps the overall policy objectives of retirement reform and divides these into short term and long term reforms. It also provides an update on the progress made to date in terms of implementing the proposed reforms.

The Broad Policy Goals of the intended reform

1. Implementing a mandatory system of retirement (auto-enrolment)

   Problem: It is not compulsory for employers to provide their employees with any type of retirement plan. Given the high costs and complexity associated with providing an employer-sponsored scheme, many employers opt not to facilitate retirement funding for their employees. This results in a large number of employees having no access to any retirement planning.

   Reform measures: Implementing a mandatory system of retirement savings will make it compulsory for all employers to provide a retirement fund for their employees. This will go a long way in improving the coverage of retirement funds.

2. Improving Preservation

   Problem: A person resigning from their employer, or withdrawing from their pension or provident fund for any other reason, may opt to take their retirement savings as a lump sum instead of preserving it. Due to financial hardships, many people would rather have their retirement savings paid to them as a lump sum. The problem is that while the lump sum payment may provide some short term relief, in the long term it results in inadequate retirement savings and a potential burden on the state. Having a large number of active members consistently withdraw from the retirement system has a knock on effect on the costs in the retirement system because the costs now have to be shared by the remaining members. The more people participating in the system, the lower the costs will be.

   Reform measures: Implementing compulsory pre-retirement preservation. Upon withdrawing from a fund, a member will no longer have the option of taking his retirement savings as a lump sum. Instead, he will be required to transfer it into another fund.

3. Improving fund disclosure

Problem: There is currently no prescribed format or procedure that funds must follow when disclosing fees or charges to their members. Statements are complex, at times not all charges are disclosed and members are not always aware of what they are paying for. This also makes it very difficult to compare retirement products.

Reform measures: National Treasury has conducted intensive research on charges and charge disclosure in the retirement system. Their findings reveal that the required level of charge disclosure to members in both commercial and non-commercial retirement funds is low. With the proposed reforms, National Treasury intends to improve the way in which charges are communicated to members, by mandating specific disclosure requirements for funds.

4. Getting defaults right

Problem: Members are usually given the opportunity to select the portfolio in which their retirement savings will be invested. There are a number of factors influencing this decision, such as the member's age, years to retirement and risk appetite and the current economic landscape. When members exercise their choice, it is taken that they have done so after taking into account all relevant factors. But what happens when members fail to choose an investment portfolio? Their retirement savings are automatically invested in what is called a default portfolio. There are currently no regulations in South Africa that require funds to create a default portfolio or that lay out the requirements that defaults should comply with. This results in the default portfolio not always being the correct portfolio to meet a particular member's needs and optimise their retirement investment.

Reform measures: Choosing the correct default options is important. These default options must form part of the fund's investment strategy. There are intended reforms that aim to prescribe specific requirements with which defaults should comply to guide trustees when choosing a default option.

5. Fund Consolidation

Problem: There are currently over 3 000 active retirement funds in South Africa. Most of these funds are small and lack the economies of scale and strong governance required to operate effectively. The high degree of diversity makes it both difficult and costly to transfer retirement savings between schemes and increases the need for clients to seek professional financial advice.

Reform measures: National Treasury will implement reforms aimed at consolidating and increasing the degree of standardisation in the structure, investment and benefit offerings between funds. Consolidation and standardisation will ensure that funds are able to achieve greater economies of scale and make it easier to transfer from one scheme to another.

6. Simplifying retirement savings products and making them portable between providers

Problem: The high costs associated with retirement planning are driven by the complexity of the retirement products on the market. Providers seem to compete on the basis of complex product designs instead of creating simple, value for money products. Currently members are not able to transfer to a new service provider with their existing products and packages. This makes it difficult for them to shop around and negotiate the same products at a more reasonable cost.

Reform measures: National Treasury will implement reforms aimed at simplifying retirement products and increasing the portability of products between different providers. Simpler, more portable products will mean increased competition between providers and will incentivise market innovations that lower costs.

7. Ensuring effective intermediation

Problem: Products are designed taking into account the remuneration paid to intermediaries selling insurance products like retirement annuities. This contributes to the complexity and high costs of retirement products. Insurers usually pay the intermediary's commission upfront but spread the costs of the commission over the lifespan of the policy. When policyholders surrender the policy prematurely, they are charged a penalty in order for the insurer to recoup the costs of the commission. High upfront commission may also create conflicts of interests between the financial adviser and member.

Reform measures: National Treasury intends to replace sales commission on insurance policies with transparent fees negotiated between intermediaries and their clients. There are indications that rebates in investment platforms will be phased out, simplifying the layered charging structures on investment platforms.

8. Providing tougher market conduct regulation and more effective supervision

Problem: The 2008 Global Financial Crisis has heightened the need for more effective financial regulation. As with recent global reforms to the banking and insurance sectors, the regulatory system governing the retirement industry will also need to undergo reform making it tougher and more intrusive.

Reform measures: The Registrar of Pension Funds is preparing various draft regulatory instruments intended to implement changes to the Pension Funds Act, aimed at improving fund governance and promoting the consolidation of funds.

Progress on the implementation of retirement fund proposals in 2013

Five technical discussion papers were released during 2012 and 2013. Some of the proposals suggested in these papers were implemented during 2013 after consultation with industry stakeholders.

1. Amendments to the Pension Funds Act

There were a number of amendments made to the Pension Funds Act. The relevant amendments were discussed in Legal Updates 5 – 8 of 2014. These amendments stemmed from proposals made in the paper titled '*Preservation, portability and governance of retirement funds*' released in September 2012. The amendments are aimed at strengthening the governance of retirement funds by empowering the Registrar to impose fit and proper requirements on pension fund trustees, requiring that all trustees undergo prescribed training, clarifying that a trustee owes a fiduciary duty to both the members of the fund and the fund and imposing a 'whistleblowing' obligation on trustees. Employers will be held personally liable for the non-payment of contributions.

2. Tax Reforms

There have been a number of changes to the tax treatment of retirement benefits, particularly from a provident fund. These changes are aimed at encouraging preservation and annuitisation. These changes have been discussed in Legal Updates 3 and 4 of 2014.

From 1 March 2014, the tax free lump sum amount paid on retirement has increased from R315 000 to R500 000, whilst the tax free pre-retirement benefit has increased from R22 500 to R25 000.

The 2013 Charges Paper

National Treasury conducted an investigation into the charges associated with retirement planning and published their findings in a paper titled '*Charges in South African Retirement Funds'.* The paper proposed measures for lowering costs that are in keeping with the broad policy objectives of reform. A mandatory retirement system and automatic preservation are seen as key factors that will reduce costs in the retirement system, while improved disclosure and effective intermediation will raise awareness around issues relating to charges.

After considering the submissions from the industry, the National Treasury has concluded that the high costs in the retirement system are driven by a combination of fundamental economic factors (the high unemployment rate and low participation rate), the current structure of the retirement system (lack of preservation and the large number of small funds) and poor market conduct practices (lack of transparency around charges, potential conflicts of interest).

Reform timeline

National Treasury announced the following draft time line for the implementation of the outstanding reform proposals. They will consult after the publication of each policy measure.

What?	By whom?	When?
Report on the Retail Distribution Review: draft proposals regarding intermediary remuneration and rebates on investment platforms.	Financial Services Board (FSB)	**May 2014**
Draft regulations on fund default investment portfolios, annuity products & preservation products for consultation.	National Treasury (NT)	**May 2014**
Policy report on extending retirement system coverage with an emphasis on vulnerable workers.	NT	**Late 2014**
Draft regulatory instruments on trustee training, 'fit and proper' requirements, improved fund governance – particularly for multi-employer funds, unclaimed benefits funds and beneficiary funds - and consolidation and harmonisation of funds. Draft regulatory instruments to improve legacy products.	FSB	**Late 2014**
Draft regulations on charge quantification and disclosures for retirement funds.	NT	**Early 2015**
Draft amendments to Income Tax Act and Pension Funds Act to implement pre-retirement preservation proposals.	NT	**Early 2015**
Draft regulatory instruments to improve coverage of the retirement system, with an emphasis on vulnerable workers.	NT	**Early 2015**
Draft regulatory instruments to improve product simplicity and portability. Draft regulatory instruments to rationalise public pensions.	NT & FSB	**Late 2015**

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