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Recent Papers issued by National Treasury

1. The National Treasury Paper on Commercial Umbrella funds

1.1 On 12 December 2021, National Treasury issued a paper on the governance of commercial umbrella funds.

1.2 National Treasury have aimed for some time to reduce the number of retirement funds operating in the market. They are of the view that although the number of retirement funds has substantially reduced over the last thirty years, South Africa still has too many registered retirement funds. It is often not economic for an employer to operate its own retirement fund and therefore many employers have opted to participate in a commercial umbrella fund, in particular the umbrella funds operated by large insurers and pension fund administrators. However, many commercial umbrella funds have failed to deliver the value for money outcomes for members that should be achieved due to economies of scale.

The 2010 Compass Survey indicated, at that point, that the commercial umbrella funds operated at almost double the cost of privately administered funds. Since then there has been significant consolidation into umbrella funds from private funds and the increased scale has not led to better value for retirement fund investors. Although some of these funds are well-run and the interests of members are protected, National Treasury is concerned about the governance of other large umbrella funds and of the consequences of poor governance for member outcomes. This may refer to umbrella fund sponsors, through controlling the trustee appointments, not enabling stakeholders to actually benefit from the independence of thinking a board is supposed to have. The sponsor being appointed to fulfil all or most functions is unlikely to yield the best outcome for fund members.

1.3 In the paper, National Treasury identified the following three major concerns regarding the operation of commercial umbrella funds:

1.3.1 Governance

The lack of member representation on the board of management of most umbrella funds has meant that the members of the board of trustees, even the so called ‘independent’ trustees are usually appointed by the sponsor of the umbrella fund. The interests of the board members are therefore not properly aligned to the interest of the fund members. The board members’ appointments are dependent on the sponsor, and not on fulfilling their fiduciary responsibilities correctly.

1.3.2 Provision of Services

Many of the large umbrella funds are locked-in to the services provided by the sponsor, in particular the provision of risk benefits and the availability of investment options. This can lead to excessive costs and inadequate services due to the lack of competition. Seshego’s experience is, even where the large funds provide a choice of insurance carrier, the premium pricing of alternative insurance pools is set by the fund sponsor.

1.3.3 Collection of Contributions

Administrators employed by the sponsor may be reluctant to enforce the provisions of Section 13A of the Pension Funds Act against employers who are delinquent in paying contributions to the fund. The need of the sponsor, whose objectives are commercial, to retain an employer's business is a conflicting interest with a commitment to enforce the law against late paying employers.

1.4 How can these concerns be addressed?

1.4.1 Independent Trustees

In 2018, the Financial Sector Conduct Authority ("the FSCA") issued Guidance Note 4 of 2018 which set out conditions for exemption from the requirement that fund members must elect 50 per cent of the members of the board of trustees. These included the following:

- at least half of the board of management must comprise of independent trustees;
- no decision would be valid unless supported by at least half of the board members present at the meeting, at least half of whom must be independent trustees;
- specific requirements for a trustee to be truly independent, including that an independent trustee should not have been employed by or have derived any income from the sponsor in the last five years. In reality, there are relationships where the so-called independent trustees get introduced to other appointments and business opportunities if they remain cordial with the sponsor, and there is not necessarily a direct payment from the sponsor.

These requirements were set out in a guidance note issued by the FSCA, which does not constitute legislation, and it is not clear at this stage to what extent the FSCA have applied the principles of the note when granting exemption from the requirement to elect member trustees.

1.4.2 Management Committees

1.4.2.1 In 2021, in discussion with representatives of the Institute of Retirement Funds ("the IRFA"), the FSCA advised the industry that they intended to look at changing legislation to provide for member representation in commercial umbrella funds.

1.4.2.2 In the December paper, National Treasury stresses the need for member representation, especially given that in the era of defined contribution funds the members bear the investment risk in such funds. National Treasury considered a few overseas models which could be applied in the South African context, in particular the Independent Governance Committees ("IGCs") which are a critical factor in the management of Master Trust pension schemes in the United Kingdom. The ICGs are similar to the current management committees or advisory bodies which some employers participating in South African umbrella schemes maintain. At present however, these management committees do not have fiduciary duties and their powers are limited. The ICGs in the UK play a much more significant role in the governance of the fund and accordingly their powers, duties and responsibilities are much more extensive. One of their principal functions is to assess the value for money delivered by the umbrella scheme.

1.4.2.3 It appears that National Treasury may be looking to formalise and standardise the management committees currently operating within many South African umbrella funds and will consider introducing legislation which will extend their powers and place on these 'quasi boards' the responsibility of establishing value for money for members. It is apparent that the Master Trust experience in the United Kingdom has been drawn on in compiling the paper. The experience in the United Kingdom over the past decade has seen retirement fund investor fees reduce substantially.

1.4.3 An "open architecture" umbrella fund structure

1.4.3.1 All too often, the sponsor of a commercial umbrella fund establishes the fund on the basis that the services provided by the sponsor will be used exclusively. If the trustees have been appointed by the sponsor and are not truly independent, they have no power to move the business to a different service provider.

This is particularly true if the trustee is in the employment of the sponsor, as such an employee would not be able to act in a truly independent capacity and take decisions which could prove to be career limiting.

1.4.3.2 Costs can also be deceptive – a low administration cost charged by a sponsor in order to appear competitive is frequently offset by high investment charges which have a much more significant impact on the members' retirement savings. There is much anecdotal evidence to suggest that the high cost structures of umbrella fund administration evidenced in the 2010 Compass Survey have not been addressed with the increasing scale given to these umbrella funds over the past decade.

Instead, the administration pricing has, in many cases, been lowered to indicate administration efficiency, but in reality, the resulting administration losses are being subsidised by inflated asset management fees. Asset management fees for unitised portfolios are deducted within the product and are not as visible as fees deducted from contributions.

1.4.3.3 The solution to the issues identified above may be in an umbrella fund with an 'open architecture' structure. This means that:

- the participating employer is not tied to the services provided by the sponsor but is free to choose among various organisations providing risk benefits and investment expertise to select the best terms and the most suitable provider for its membership profile;
- segregation of the administration and asset management minimises risks and improves transparency;
- the board of trustees is truly independent and not beholden to the sponsor and is therefore able to hold service providers to account and to act in the best interest of the membership.

National Treasury has said that it would like to initiate a consultation process with the retirement industry, trade unions and other interested stakeholders to improve the governance of commercial umbrella funds. The objective is to deliver better value and protect the interests of the members enrolled in these funds.

2. National Treasury Paper on Encouraging South African Households to save more for retirement

2.1 The National Treasury paper aims to balance the need for limited access to retirement savings while members remain in employment with the imperative of encouraging a higher level of retirement savings. At present, only 6% of the total membership of retirement funds are adequately funded for retirement i.e. they achieve a replacement ratio of 75% of the salary they were earning before retiring. The replacement ratio approach has its limitations, and the “conversion risk” of capital into income at retirement needs to receive better attention in formulating retirement plans.

National Treasury envisages a two-pot system, in which one-third of the member’s retirement savings would be held in an access pot, to which members would have limited access and the remaining two thirds would be held in a preservation pot and would have to be preserved till retirement. The date of implementation of the legislation has not yet been finalised, but it is likely to be in 2023. The industry has asked for a 12-month lead-in period in order to make the necessary changes to administration systems. After T Day on 1 March 2021, when retirement savings were already split into a vested and non-vested portion, adding the two-pot system on top of the already divided record keeping makes for complex administration in an industry where there are several examples of administration failures, even before T Day.

2.2 How would this work? Nothing has been finalised in legislation so the scenario below is based on proposals from industry bodies such as the Institute for Retirement Funds Africa (“the IRFA”) suggesting how the two-pot system could work in occupational funds.

2.2.1 Protection of the Accrued Benefit

The members net contributions plus investment return prior to 1 March of the implementation year (“the accrued benefit”) would be protected. This would mean that a member who had been in a retirement fund for 5 years prior to the date of implementation and had an accrued benefit of R200,000 would be able to access the full accrued benefit in cash on leaving the service of the employer at any stage in the future. Going forwards, his retirement savings would be divided into the access pot and the preservation pot.

2.2.2 The Access Pot

The access pot would contain one-third of the member’s net contributions plus investment return made after the implementation date. Limited access would be allowed, possibly once a year subject to specified maximum amounts. Money withdrawn from the access pot should be for emergency use only. The difficulty is that emergency is not defined, and the IRFA prefer this as they do not want there to be an additional fiduciary responsibility for the trustees i.e. the trustees should not have to decide which members are eligible to withdraw an amount from the access pot.

Members would bear the cost of all withdrawals.

2.2.3 The Preservation Pot

The preservation pot would contain two-thirds of the member’s net contributions plus investment return made after the implementation date. This amount could not be accessed until retirement.

2.2.4 Covid Relief

The National Treasury paper recognises the need for some form of Covid relief. However, the effects of the Covid pandemic could be much less severe by 2024, if this is the date when the system becomes operational.

Further, it would take some time for any member's access pot to build up to the minimum of R2,000 suggested by National Treasury. The IRFA have suggested that members could be allowed limited access to the accrued benefit. They have suggested a seed funding approach which would allow limited amounts to be transferred from the accrued benefit into the access pot, with a minimum amount of R2,000 and a maximum of 10% of the benefit, subject to a maximum of R25,000. To avoid the trustees having to exercise any discretion, this would apply to all members automatically.

2.2.5 Taxation

NT have indicated that the current tax regime is not appropriate for taxation of withdrawals from the access pot. The IRFA have suggested various ways in which a new tax dispensation could work. However, this is speculative and there is no point in detailing the proposals at this stage.

2.2.6 Other vehicles for Retirement Funding

The National Treasury paper indicated that the two-pot system should also apply to preservation funds and retirement annuity funds but provided no detail of how the system would operate in these vehicles. However, beneficiary funds and unclaimed benefit funds are excluded. There is no comment at this stage on how the accessible pot in the two-pot approach may integrate with Tax Free Savings Accounts and their tax treatment harmonized.

The budget speech in February 2022 may provide more clarity on the details of the system, any tax changes and when the legislation is likely to be finalised.