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In case you missed it…

1. March 2023: Deductions in terms of Section 37D of the PF Act
2. February 2023: Budget summary 2023/2024 Tax Year

SUSTAINABILITY OF RETIREMENT FUNDS – AN OVERVIEW

1. Why is it Important that Retirement Funds are sustainable?

South Africans are notoriously poor savers and currently only 5 percent of South Africans retire in comfort. Changing social patterns mean that families no longer have the capacity or sometimes even the inclination to support elderly relatives. This is a major concern for National Treasury as it means that the majority of improvident citizens end up relying on the state to support them in old age.

If utilised properly, retirement funds are attractive vehicles for saving towards a comfortable retirement, both from the perspective of National Treasury and the member. The major advantages are:

- A beneficial tax regime, which means that contributions to the fund are tax deductible and the member is not taxed on the build-up of his investment. Tax is only payable on the end benefit, but even then part of a lump sum payment is tax-free i.e. R550 000 can be taken tax-free on retirement or retrenchment. Then, there are significant tax planning opportunities when over the age of 65 for retirement fund monies put in an annuity;

- Membership is compulsory once a member enters the service of an employer who participates in a retirement fund;

- Participation in group risk benefit schemes so that employees are protected from loss of income due to disability and their families can be compensated financially in the event of unexpected death.

- The fund members' interests are protected by regulatory authorities such as the Financial Sector Conduct Authority ("the FSCA") and the Pension Funds Adjudicator;

- Funds are managed by a board of trustees, who are charged with the fiduciary duty of taking greater care with the management of the assets of fund members than they would of their own financial affairs.

It is therefore in the national interest that retirement funds should continue to be sustainable.

2. What are the current factors potentially threatening the sustainability of retirement funds?

2.1 Expenses

The cost of administration and other incidental expenses have risen steadily over the years. The following issues have all contributed to rising costs:

- Compliance with legislation can be costly. Administrators need the assistance of trained professionals in the accounting, legal and actuarial fields in order to manage regulatory requirements. Such specialised skills are expensive.
  The proposed "Two-Pot" system which will come into effect on 1 March 2024 is complex and means that administrators will have to change their systems to be compliant.

  The effect is that it has become more difficult for a smaller administrator to operate in this environment and boards of retirement funds have to select an administrator appropriate for the needs of their fund from an ever-decreasing pool.

- The move to umbrella funds means that in order to obtain exemption from the requirement to elect member trustees, board members of these funds have to be independent, skilled and experienced. Such independent professionals are usually remunerated by the fund.

  A recent survey by PwC ("the PwC Survey") indicates that 47% of retirement funds remunerated their boards in 2020 and that the number has increased to 74% in 2023. The PwC Survey shows that the remuneration paid to board members has not risen substantially over the last few years, but it is nevertheless a substantial cost for the retirement funds surveyed.

- Each retirement fund must have a principal officer who in terms of subordinate legislation issued by the FSCA must be independent. The PwC Survey found that eighty-two percent of the respondents indicated that the principal officer of the fund was remunerated. Usually, the remuneration of the principal officer was determined by the board of trustees.

- The administration fee is usually set out in a contract between the administrator and the board of the fund and is therefore transparent. However, this is not the case with the fees involved with the investment of the fund's assets. Many asset managers fail to properly disclose the costs associated with the trustees' choice of investment portfolios and an unwary board of trustees can end up paying far more in hidden costs associated with investment management than they intended e.g. in performance fees.
  Such costs eat into the investment returns earned on the members' benefits, and can have a greater impact than the administration fee on the end benefit.

> These PwC Survey observations clearly apply to commercially run funds, and occupational schemes within an employer group have different cost structures.

2.2 Legislative environment and over-regulation

The stated aim of the FSCA is to:

> *"Supervise retirement funds and benefit administrators on an on-going basis to ensure compliance with the duties imposed by the Pension Funds Act at all times and take necessary regulatory action against non-complying entities".*

The FSCA has stated repeatedly that its main concern is to protect the interests of the fund members. However, as mentioned above, compliance with the various regulatory duties imposed on retirement funds by the FSCA is costly and ultimately affects the benefits of members. The FSCA has also shown a tendency to micro-manage retirement funds and to interpret the Pension Funds Act and subordinate legislation in a manner that goes beyond the original intentions of the legislature. For example, the FSCA has recently refused to grant valuation exemption to funds for reasons other than those specified in the board notice specifying the conditions for valuation exemption.

Given the cost of appointing a valuator and of submitting triennial valuations, refusal to grant valuation exemption can result in a significant additional cost for the fund which will ultimately impact members' benefits.

2.3 Poor Investment Returns

World economies are still reeling from the effect of the Covid lockdowns and investment markets have to contend with worldwide political and financial turmoil. In this environment, investment return was generally relatively poor. It is important for boards of trustees and for those who consult to them to stress that saving for retirement is a long-term exercise and historically, high exposure to equity, which is the typical vehicle for retirement investment has outperformed other investment mediums, including cash and property. Appropriate communication to members is critical.

2.4 Compliance with POPIA and cybersecurity

Retirement funds are juristic entities and as such are responsible for compliance with the provisions of POPIA. A breach of POPIA can result in criminal action being taken against the organisation concerned. Unfortunately, cybersecurity attacks are on the increase across the industry. The PwC Survey indicated that 11 percent of the retirement funds participating in the survey had experienced a cybersecurity threat or attack during the most recent financial year of the fund.

Cybersecurity is therefore a key business risk and funds need to maintain appropriate insurance to mitigate the effect of a POPIA breach or a cyberattack on the fund.

2.5 Early withdrawals

It is relatively unusual in today's working environment for an employee to enter service with an employer and remain with the same employer until retirement. Given the lack of a savings culture in South Africa, employees frequently take their withdrawal benefit in cash, pay the relatively punitive tax and spend the remaining amount on more immediate needs rather than preserving the benefit till retirement. The effect of this practice on a smaller free-standing fund is consequently fewer assets to invest. Given the ongoing increase in regulatory expenses, early withdrawals are a threat to the sustainability of a relatively small freestanding fund.

3. What can be done to promote the sustainability of Retirement Funds

3.1 The Employer

Historically, employers played a larger role in the fund's decision-making process, especially in the case of defined benefit funds when the employer was liable for payment of the end benefit and as such had a major stake in the investment vehicles used by the fund. In a defined contribution environment, the risk of poor investment performance impacts the members and the employer's liability is limited to timeous payment of the contribution required in terms of the fund rules.

However, there are still critical decisions for an employer with a retirement fund. The most important decision is probably whether it is more cost-effective to maintain a free-standing fund or to become a participating employer in an umbrella fund. Whether being locked into the services of the umbrella fund sponsor means the future cost increases cannot be controlled, and the duplicate cost of the free-standing fund whilst it is being closed are important considerations.

It is usually assumed that umbrella funds offer economies of scale. This is not always true, however, and the employer needs to do careful research and obtain advice from an experienced consultant before making this decision. Some umbrella funds even offer "free" administration, which is obviously not the case when the total cost structure is considered. In a free-standing fund, the employees elect half the board of management and have a voice in decision-making. This may be preferable for a company whose only responsibility is then to pay the contributions defined in the rules, whereas where the company selects an umbrella fund the company is accountable for the resulting efficiency of the umbrella fund it picks. The disadvantage of moving to an umbrella fund that does not provide flexibility in the choice of suitable investment portfolios and insurance providers is that the company loses control over these two largest cost levers.

The alternative is an "open architecture" umbrella fund. Such funds offer the client (the employer) a bespoke solution by allowing the client to decide where to place cover for risk benefits, and a selection of well-priced investment portfolios. This approach is likely to deliver better value for the company and employees over time.

3.2 Board of Trustees

The board of trustees ("the Board") is directly responsible for the management of the retirement fund. The Pension Funds Act allows them to outsource functions related to the day-to-day running of the fund to an administrator but they remain responsible to ensure that proper control systems are maintained by and on behalf of the Board. The Board's choice of service provider is critical. An employer in a free-standing fund has more freedom to select the service providers most suited to the fund's needs, and particularly the fund's administrator.

The fund administration is the "shop window" of a retirement fund. An employer participating in a commercial umbrella fund will find that the administrator chosen by the Board is linked in some way to the sponsor.

Further, the members of such a Board may not be truly independent of the sponsor. The PwC Survey indicates that 9 per cent of board members of specialised funds are remunerated directly by the sponsor and 16 percent by the fund and the sponsor taking a joint decision on remuneration. Good governance therefore comes at a price, and it is noteworthy that the survey also demonstrated that the number of board members of both free-standing and umbrella funds is reducing.

The duties imposed on the Board by legislation are highly onerous. To maintain the sustainability of the fund and perform their duties effectively, it is important for board members to be conversant with legislative and other changes in the retirement environment. They also need to enlist the support of superior service providers who understand the membership profile of the fund and are able to source best-of-breed solutions for its specific needs. The independence of the Board is a major factor in deciding on the service provider.

Certain functions of the Board, such as management of the distribution of death benefits in terms of Section 37C of the Pension Funds Act have become so complex and open to litigation if the trustees get it wrong. It is preferable to outsource this duty to a specialised service provider. Unfortunately there are few organisations in the South African market able to provide specialist services at a reasonable cost.

3.3 Service Providers

The three main service providers which impact the sustainability of the retirement fund are the following:

3.3.1 The administrator

As mentioned under 2.1 above, the administration of retirement funds is becoming increasingly complex. This has resulted in the elimination of the smaller administrators from the market and the choice of administrator has become increasingly limited. A large administrator will usually be well-resourced with competent legal, actuarial and accounting departments.

However, there may be pressure for the Board to use the administrator as a “one-shop” facility which may not be suitable in all cases for the membership profile of the fund. It is important for the Board to regularly review the performance of the fund’s administrator, with a view to assessing whether the administrator’s fee structure and performance remain competitive.

3.3.2 The asset manager

The PwC Survey revealed that more than 32% of the respondents said that the fund’s investments were managed by more than 20 asset managers and only 25% indicated that they made use of fewer than 10 asset managers. The survey revealed that funds with an active investment strategy need to make use of more asset managers than those with a passive investment strategy. Making use of a large number of asset managers, while it may promote investment diversification, places a greater responsibility on the Board to critically monitor and review their performance. The PwC Survey recommends that funds should review the performance of the asset manager against International Standard on Assurance Engagements 3402 reports.

The Board also needs to make sure that all fees and expenses associated with the acquisition, holding or disposal of assets are fully and transparently disclosed by the asset manager. Hidden fees are insidious since they eat into the investment returns earned on the member’s savings and can defeat the long-term objectives of the fund.

3.3.3 Benefit Consultants

The major administrators of retirement funds employ consultants who usually have extensive experience in the retirement funding industry.

However, such consultants will naturally tend to promote the products and services provided by their employers and are thus unlikely to be able to provide unbiased advice to retirement funds and participating employers.

Ideally, an organisation providing consulting services to retirement funds should be independent and thus in a position to recommend the products and services best suited to their client and the needs of the members of a particular retirement fund.

Independent advice given by a consultant can be a major contributor to the sustainability of a retirement fund. A good consultant can provide the Board with the necessary technical knowledge of investment and risk products and of changes in the legislative and regulatory environment. The Board will then be in a position to make informed decisions that benefit members and promote the objectives of the fund, and avoid some of the pitfalls highlighted here.

3.3.4 The Two-Pot System

Initially, the two-pot system will be complex and expensive to administer. There will in fact be at least three pots since the accumulated benefit of members immediately prior to 1 March 2024 will be separately maintained and the old rules will continue to apply to this part of the retirement benefit. However, over time the current complexities will be eliminated.

Preservation of two-thirds of the retirement benefit is mandatory under the new system. This will increase the assets in retirement funds available for investment and prevent the leakage currently created by early withdrawals. Enforced preservation will contribute to making retirement funds more sustainable in the long term, and open up investment options where liquidity constraints are a factor

Should you have any questions regarding the above, please contact your consultant to assist you.