DASHBOARD
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NATIONAL TREASURY'S DISCUSSION PAPERS - DECEMBER 2021

Two Discussion Papers issued by National Treasury

On 14 December 2021, National Treasury issued two Discussion Papers, for consultation:

1. Encouraging South Africans to save more for retirement - which deals mainly with the two-pot system and auto-enrolment; and
2. Governance of umbrella funds.

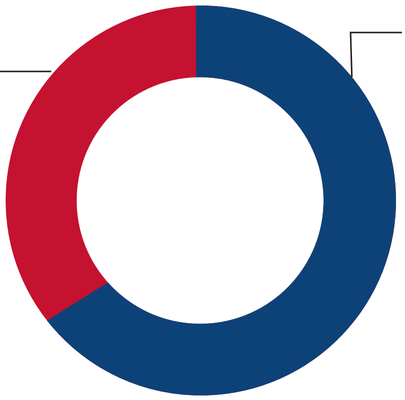
Comments are due on or before 31 January 2022. The Papers can be found on the National Treasury website: Treasury.gov.za. The necessary legislation will be drafted as part of the 2022 Budget process.

Government notes that it needs to proceed with caution given the macro-economic issues facing the country and because the pension system is a key pillar of the South African economy.

Summary

The Discussion Papers include the following proposals for discussion:

A. The two-pot system which restructures retirement funds into two pots:



Pot Two can be accessed at any time (with some restrictions) for any reason even when the member is still in employment. One-third of net contributions starting from a date to be decided will go into this pot.

Pot One cannot be accessed until retirement, even on termination of employment. Two-thirds of net contributions starting from a date to be decided will go into this pot.

- Rights related to vested amounts - that is, amounts already accrued in retirement funds before the implementation date of these changes - will be protected. There will be some allowance, after the implementation date, for amounts to be withdrawn from vested amounts when members resign from employment in the future.
- Immediate partial access: National Treasury is considering whether members in greatest need should upfront be allowed a once-off partial access to their retirement savings subject to a maximum.
- Preservation funds, retirement annuity funds, and defined benefit funds will be part of the two-pot system (with the necessary changes and protection of existing rights).
- Taxation within the retirement funding system will need to change.

B. Auto-enrolment proposals

- Auto-enrolment to cover a broad spectrum of all formal salaried employees as a first step.
- The next step would be coverage for the informal or vulnerable sector.
- Legislation to compel all employers to deduct contributions to an existing occupational fund or another approved fund, for all their employees.

Umbrella funds

- Discussions to improve governance, with particular attention to commercial umbrella funds.
- Consideration of international experience, in relation to umbrella funds, in particular, the Master Trust market in the United Kingdom.
- Umbrella funds may be required to set up and maintain 'quasi-boards', similar to the UK's independent governance committees, which could be formalised and standardised in South Africa and must assess value for money for members.
- Value for money assessments and other aspects of the UK Master Trust system may find their way into our system.
- A central auction system could be set up for boards of funds that don't meet value for money criteria to enable these funds to select and appoint existing default 'consolidation' or auto-enrolment funds when required. The boards of these funds could request boards of existing funds to take over their fund.
- No lock-in of umbrella fund providers.
- Additional measures related to disclosure of costs and charges.

1. Discussion Paper: encouraging South Africans to save more for retirement

This Paper deals mainly with the two-pot system and auto-enrolment.

National Treasury states that outstanding retirement fund reforms relate to the following three remaining problems:

- "Coverage: Whilst the current retirement system covers many workers, there remains significant categories of workers who are not participating in any retirement scheme;
- Preservation: Many members of retirement funds do not preserve their savings, tending to cash out every time they change jobs. Whilst the default regulations do assist with preservation, significant loopholes remain; and
- Costs: Whilst the costs applying to retirement funds might be more transparent, most of the cost structure of retirement funds relates to the size and number of funds, which are not economical".

In addition to outlining the two-pot system, the proposals include legislation to enable automatic/mandatory enrolment of South Africans into retirement funds to expand the retirement funds coverage for more vulnerable, contract, temporary workers and those in the gig economy[1].

Consolidation of retirement funds remains an objective focusing on ensuring funds can take advantage of economies of scale, improved governance, and disclosure.

A. The two-pot system

The basics of how the two-pot system is proposed to work

This system is aimed at allowing limited withdrawals from funds whilst members are still in employment but at the same time ensuring more retirement savings are preserved until retirement.

[1]*"Gig economy" means "a labour market characterized by the prevalence of short-term contracts or freelance work as opposed to permanent jobs" – Oxford Languages.*

- The Paper identifies that there are two main design problems with retirement funds that lead to low savings when members of retirement funds retire:
- insufficient preservation of retirement funds before retirement, that is, when members leave employment they cash out their retirement savings; and
- members of funds can only access their retirement savings (pre-retirement) if they resign from employment.

National Treasury is faced with resolving two conflicting imperatives:
- encouraging South Africans to save more for retirement; and
- allowing South Africans in financial distress to access a portion of their retirement savings in retirement funds without leaving employment.

National Treasury acknowledges that retirement savings should be used for their intended purpose but that there is a need to allow some access to retirement funds for South Africans before retirement. One of the proposals that National Treasury is considering is the two-pot system which restructures retirement funds into two pots.

Pot one – retirement pot	**Pot two- access pot**
Preserved until retirement, thus not accessible before retirement	May be accessed at any time for any reason
Member must retire to gain access to this pot	Members do not need to resign from employment to gain access to this pot. Member can gain access whilst still a member and still in employment But a restriction (e.g. once a year) on the amount of times it can be accessed. Unless the full amount is not accessed in any year, in which case another withdrawal in the same year is allowed There may be a minimum amount that must be in this pot before it may be accessed, for example R2 000
Two-thirds of net contributions starting from date 202X (date to be decided) to go into this pot (net of risk premiums and administration charges)	One-third of net contributions starting from date 202X (date to be decided) to go into this pot (net of risk premiums and administration charges)
	Withdrawing member pays for the cost of the withdrawal Member will have to update his contact details and may be required to undergo retirement benefit counselling/ financial awareness prior to access After accessing, the member should have the option to increase their contribution rate
Investment growth accrues on the contributions in this pot	Investment growth accrues on the contributions in this pot

Vested amounts – that is, amounts already accrued in retirement funds before the implementation date of these changes

The question remains as to how amounts that have already been accrued in retirement funds, on the implementation date of these new changes, will be treated in the two-pot system. In the Paper, National Treasury calls these amounts "vested amounts" (not to be confused with the so-called vested amounts brought in by compulsory annuitisation on 1 March 2021).

There will be some allowance, after the implementation date, for amounts to be withdrawn from vested amounts when members resign from employment in the future. If a person starts a new job after the implementation date, then there will not be any amounts allowed to be paid on resignation after this date unless vested amounts were transferred in from another fund. National Treasury has asked for comments on how vested amounts can be protected.

Preservation funds

The two-pot system will apply to preservation funds. Preservation funds do not have contributions but have amounts transferred into the preservation fund. The vested rights provisions described above are intended to apply equally to amounts transferred into preservation funds before the implementation date.

Amounts transferred into the preservation fund would mirror the structure of the transferor fund. Members transferring into a preservation fund would still have access to amounts in the access pot in the preservation fund that they had access to in the transferor fund.

Members would not be able to access amounts in the retirement pot until retirement.

If any vested rights are transferred into the preservation fund, then a once-off withdrawal right would apply to that amount (even after the implementation date).

If a member of a preservation fund has not yet accessed their once-off withdrawal and the implementation date passes, the member will still have their once-off withdrawal option on the full amount.

This is explained again in the table below.

Pension Preservation Fund or Provident Preservation Fund			
Access pot (transferred in from transferor fund)	**Retirement pot (transferred in from transferor fund)**	**Vested amount (transferred in from transferor fund)**	**Amounts in a preservation fund where the member is in the preservation fund before the implementation date and has not taken their once-off withdrawal**
Can access as with other funds	Can't access until retirement	Once-off withdrawal right applies to the vested amount	Once-off withdrawal right applies to the whole amount

Retirement annuity funds

The two-pot system will apply to retirement annuity funds (RAFs). RAFs are different to pension and provident funds as, amongst other things, members can only access their retirement savings from age 55.

National Treasury notes that many self-employed persons contribute to RAFs. Currently loss of income could not be supplemented through a RAF, so allowing access to RAFs would decrease preservation. However, not providing access for RAF members in financial distress would not achieve National Treasury's objectives. A further consideration mentioned in the Paper is that if RAFs are included this will completely harmonise the tax treatment of RAFs with other retirement funds (except for retirement age).

The Paper notes that older generation RAFs may need more time to implement the two-pot system.

Defined benefit funds

National Treasury intends to include defined benefit funds in the two-pot system. This will be more complex than it is for defined contributions funds. Treasury, in its deliberations, considered the relative lower liquidity of investments of defined benefit funds in relation to increased withdrawals but does not appear to view this as an insurmountable obstacle.

The Government Employees Pension Fund (a defined benefit fund) will probably also be included in the two-pot system.

Immediate partial access

National Treasury is considering whether, despite the many real risks involved with this approach, members should upfront be allowed a once-off partial access to their retirement savings, for example a percentage of retirement benefits up to a maximum of R25 000.

It concludes that if immediate access is allowed this should be restricted to “those with greatest need”. This would have to be checked, for example by SARS looking at drops in income by considering IRP5 certificates or provisional tax payments.

Other considerations related to partial access include:

- whether this partial access should perhaps be limited to RAFs or preservation funds (where persons have already taken their one withdrawal) or applied across all funds;
- whether partial access should be once-off, however it is concluded that this may be a riskier approach;
- the possibility of limiting the partial access to persons who have experienced a specific threshold percentage drop in income. However, Treasury surmises this would be arbitrary and would create further distress for those persons not qualifying;
- the difficulty of administering the whole partial access approach;
- whether the partial access could be structured as seed funding for the access pot which could then be accessed immediately.

Financial distress loans to members - not on the cards

Loans to members by third parties that are guaranteed by fund retirement benefits are not considered as a favorable option for providing access to retirement funds monies for a number of reasons, including the applicability of Consumer Protection Act requirements to the loan.

Taxation

A large part of the Paper considers the taxation aspects of the proposals and how taxation may need to change to accommodate the changes. Considerations include:

- the appropriateness of the design of the taxation of contributions, growth, and benefits;
- the horizontal equity of the taxation of retirement funds versus alternative investments (including deductibility of contribution considerations in relation to both pots);
- the tax treatment of amounts withdrawn (and avoiding tax arbitrage); and
- equitable tax treatment of individuals.

The conclusion Treasury comes to is that *the current tax treatment for contributions to, and withdrawals from retirement funds is unlikely to be appropriate* if the two-pot system is implemented. Treasury spends some time in the Paper discussing alternative taxation mechanisms in relation to the one-third access pot. This will be part of the consultation process.

What is auto-enrolment, according to National Treasury? Making the employer enroll all employees in a workplace pension scheme or another approved scheme, to which the employer must make a minimum contribution; employees have the option of opting out of the scheme.

B. Auto-enrolment proposals

Government is concerned about the high number of workers that are not covered by (members of) a retirement fund because they are informal, temporary, contract, non-unionised, employees of small companies, low income, probationary, or gig economy workers as well as sole proprietors or independent contractors. In addition, 30% of workers in the formal sector are not in retirement funds. National Treasury is of the view that this is largely due to retirement funds being voluntary to join.

Thus, National Treasury proposes introducing auto-enrolment to cover a broad spectrum of all formal employees. This would improve retirement coverage and provide risk cover for such employees.

Government (as with many countries around the world) recognises the challenges of extending retirement coverage beyond salaried/wage-based employees formally employed in the public and private sector who make regular fixed contributions to more vulnerable workers.

It is stated that auto-enrolment tends to work better for formal salaried employees where there is an employer and that this could be the first step to extending coverage in South Africa. The next step would be coverage for the informal or vulnerable sector where it may be more practical to have a more voluntary system backed by strong incentives, FinTech, and a default fund.

National Treasury states that an alternative to auto-enrolment is mandatory coverage of all employees within the formal sector and then progress this to include informal sector workers.

It is stated in the Paper that Government *will propose legislation to compel all employers to deduct contributions to an occupational fund or another approved fund, for all their employees*. This would not require employers to establish new funds. Employers would enroll their employees into existing funds, which funds would have to bid for the provision of retirement services or products (see more information on this auction/bid system below).

C. Request for comment on specific questions

In the Paper, National Treasury has asked for comment on specific questions around balancing accessibility with preservation, coverage, and enrolment as well as consolidation and governance, for example:

- Given that retirement savings are often not enough to last well into retirement, further exacerbated by the effects of Covid-19, should there be immediate access to retirement benefits or consideration of a buildup of the accessible savings pot over time before allowing access? Under which conditions should either of these two instances be permissible?
- How best can mandatory enrolment be implemented?
- How can Government facilitate increased consolidation of retirement funds?

2. Discussion Paper: governance of umbrella funds

Umbrella fund governance

This Paper addresses issues that relate to umbrella funds, stand-alone funds, sponsors, employers, and members. National Treasury states that while some umbrella funds (multi-employer funds) appear to be well run, it is concerned about the governance of others and the effect that poor governance has on member outcomes. Governance challenges of umbrella funds, according to Treasury, include:

- Over-dependance of board members on product and services providers for advice;
- Conflicts of board members between loyalties to members and those who elected or appointed them;
- Rules of funds that tie funds to specific service providers or compel members to remain enrolled when members or employers believe there is better value for money elsewhere.

Thus, National Treasury will embark on a consultation process with industry, labour unions, and interested stakeholders on measures to improve governance.

Commercial retirement funds

The Paper states that particular attention will be paid to colloquially called *commercial umbrella funds* during this process. Treasury states that *commercial retirement funds* are those that have been established by financial services providers to drive new business to themselves and related parties and are operated as if they are parts of the businesses of those for-profit organisations.

Concerns with umbrella fund governance

Treasury notes that multi- employer funds can offer cost advantages allowing small employers to achieve economies of scale they would not otherwise have been able to enjoy in a small occupational fund. However, Treasury also notes several disadvantages of multi-employer funds, such as:

- lack of member representation on the board of management, leading to concerns that the interests of sponsor-appointed board members do not align with members' interests, for example, the board not really having the power to fire the sponsor companies, engagements not being at arm's length and the board not being truly independent because half the board is made up of sponsor-appointed members;
- locking in of the fund to the sponsor's products and services leads to concerns about excessive costs that are complex and opaque and inadequate services (due to lack of competition); and
- difficulties related to participating employers not paying contributions where the administrator or fund, for commercial reasons, may not want to take action against the participating employer.

International experience and Independent Governance Committees

National Treasury has considered international experience in relation to multi-employer, commercial and other funds. In particular, it expands on the Master Trust market in the United Kingdom.

National Treasury recognises the practical difficulties of umbrella funds having employers and employees nominating and electing board members.

Within the workplace personal pension scheme space in the UK, pension schemes are required to set up and maintain independent governance committees ("IGCs"). National Treasury notes that IGCs are like independent trustees, appointed by the providers and have oversight of the multi-employer scheme. They have a fiduciary duty and are given clear duties and powers to act in the interests of members. They also undertake the value for money assessment of the pension scheme.

National Treasury likens umbrella fund management committees (sometimes called joint forums or advisory committees) to IGCs. In South Africa, management committees are not recognized in legislation but National Treasury recognises that they perform functions such as: updates to member data, ensuring that contributions are paid over to the fund, processing death benefits with the fund, providing updates to members of the fund and recommending amendments to benefit structures.

National Treasury states that these 'quasi-boards' could be formalised and standardised in South Africa and given an added responsibility of establishing value for money for members. It further states that value for money measurement criteria and tools should be established. Furthermore, a Conduct Standard should be published in which funds that are unable to demonstrate that they comply – or within a defined period will comply – with specified 'value for money' standards will be required to procure the transfer of their assets and liabilities to other funds that do comply with the criteria and then close.

Policy measures

National Treasury states that it is still of the view that most employers will only be able to achieve suitable economies of scale by joining multi-employer funds of some form. But given the concerns specified above regarding governance, Government must come up with policy options to strengthen the governance of umbrella funds, that employers are made active purchasers of retirement funds and that competition is increased in the market.

The Financial Sector Conduct Authority ("FSCA") is already working on measures to improve the governance of funds that are exempted from giving members the right to elect 50% of board members (or from having four board members) ("exempted funds"), including making King IV compulsory for funds and have already issued Guidance Note 4 of 2018.
The FSCA is looking to introduce the following additional measures:

- board members, including independent board members, to prevent them from spreading themselves too thin, should not be on more than three boards in any year, including membership of company boards; and
- independent board members should not be contracted as consultants/service providers to the same fund of which they are board members.

Employer related structural solutions

Employers can use their discretion to provide retirement solutions and as to whether to provide this through occupational funds or commercial umbrella funds.

Treasury states that it supports an auction system conducted under the FSCA to enable stand-alone funds to select and appoint default 'consolidation' or auto-enrolment funds when they need it. The ideas seem to be that providers of umbrella funds would be required to bid for the right to enroll new members of the umbrella fund, which members then remain captive for a period (for example two years). Bids must cover administration costs, internal investment costs and must be lower than the minimum fee currently available in the market.

In addition, services provided to an umbrella fund should also be subject to an open bid process, with the sponsor being one of the tenderers. This means that the use of the sponsor's services cannot be compulsory.

Treasury suggests that the auction mechanism could form part of the South African system and could, for example, work as follows:

- a central auction system could be set up for boards of small funds that don't meet value for money criteria. The board could request boards of existing funds to take over their retirement scheme;
- only pension schemes meeting strict criteria could bid for these closing funds (could be 'blind') on a standardised basis;
- or, the FSCA should establish a regular auction between umbrella funds bidding to become the default consolidation fund for a set period.

Treasury notes that the auction system could also be used to identify the default provider under any auto-enrolment system.

Other measures

National Treasury is considering introducing:

- measures to increase the disclosure of costs and charges;
- template rules for retirement funds;
- prohibiting lock-in provisions (of sponsor products and services) in rules and agreements; and
- sponsors to compete for the business of providing products and services of exempted funds.

Please contact us should you require further information.