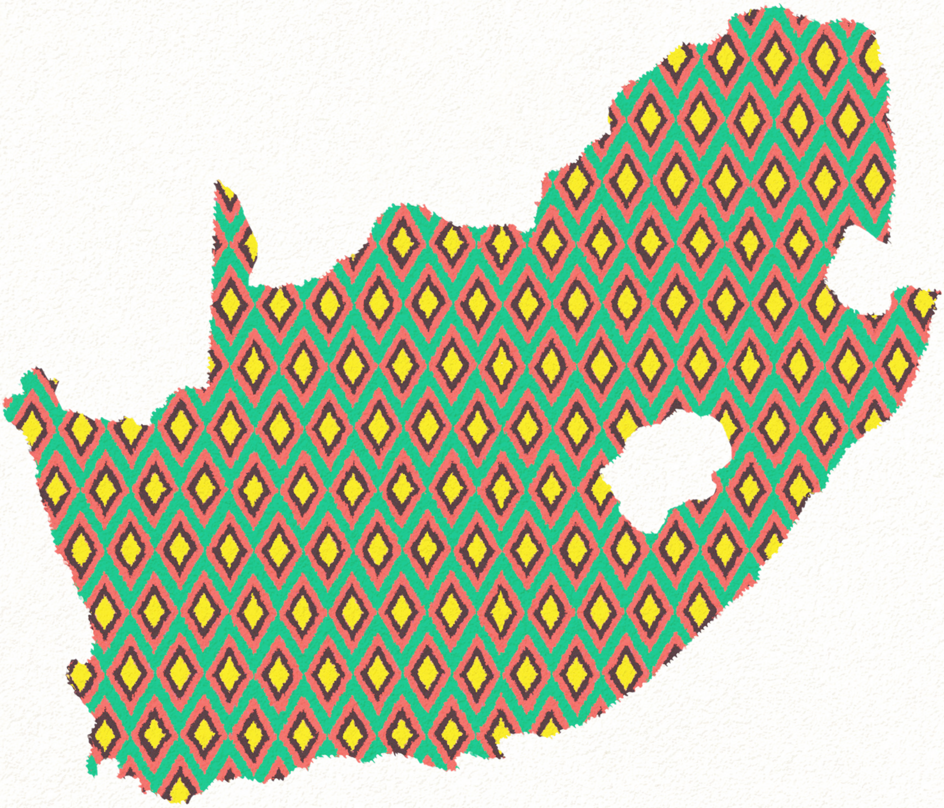

A JOURNEY TO REFORM THE RETIREMENT SYSTEM: SOUTH AFRICA'S EXPERIENCE AND PERSPECTIVE

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1. OVERVIEW

Retirement reforms are necessary but difficult for any country. They require strong political will from the Government, support from labour unions and industry, and buy-in from members of retirement funds. While South Africa's journey to reform the pension sector began in 1992, the focus of this chapter is on the reforms undertaken between 2012 and 2022.

South Africa has one of the largest retirement assets in the world, with a well-developed retirement savings industry and a sound regulatory framework. It has achieved this outcome without a national mandatory contributions pillar or fund. However, the country continues to face some challenges around adequacy of benefits, certain opaque costs, sustainability, poor coverage and suboptimal fund governance. In areas like Sustainable Finance and ESG however, South Africa has been one of the early adopters and champions.

The first phase of reform, between 2012 and 2019, sought to; (i) encourage post-retirement preservation by requiring annuitisation for all retirement products; (ii) simplify tax incentives for retirement contributions through a uniform tax treatment of various retirement products; (iii) encourage discretionary individual savings over and above retirement contributions through tax incentivised individual plans; (iv) encourage good value retirement products and services by reviewing cost structures and introducing "Default Regulations"; (v) enhance governance of retirement funds through various regulatory interventions like prohibiting certain gratifications; and (vi) encourage pre-retirement preservation to address leakages associated with resignations.

The Covid-19 pandemic has raised various issues for countries and retirement funds like sustainable finance, funding for infrastructure and whether there should be early access to retirement savings for emergencies. The second phase of reforms (post-Covid-19), were therefore focused on these issues, as also on extending pension coverage to salaried workers without retirement plans as well as to those in the informal sector, and designing pension products that appeal to the youth. In this context, one of the questions South Africa is grappling with is whether retirement funds, in their traditional sense, are suitable for low-income workers, and whether micro-pensions can assist in dealing with this cohort. South Africa's proposed "Two-Pot" system (described ahead) aims to deal with pre-retirement leakages, and the identified behavioural challenges of inertia and financial discipline. Africa is a young continent, and therefore retirement systems must be reformed and designed to also appeal to the youth.

2. INITIAL CONDITIONS AND CONTEXT DATA FOR SOUTH AFRICA

By the end of June 2022, STATSSA estimated the population of South Africa to be 60.6 million and of this number, the employed persons make up 15.6 million. The adult population (25-59) make up about 47% of the 28.2 million. According to the Rapid Mortality Surveillance Report, the mortality of older adults appears not to have changed much between 2000 and 2019, with the average life expectancy at the age of 60 rising from about 15.5 years to 16.1 in 2019 for men and around 19.3 years to 19.6 in 2019 for women.[1] The World Data Atlas[2] states that in 2020, the population aged 60+ years for South Africa had life expectancy of 16.49 years for both sexes.

About 10.5 million persons are employed in the formal sector (non-agricultural) compared to 4.9 million employed in the informal, agriculture and private household sector. The economic shock resulting from the onset of Covid-19 saw distributional channels of income support for individuals drying up as the formal sector employment declined, with around 4 million South Africans losing their jobs because of the Covid-19 pandemic and subsequent lockdowns. The official unemployment rate stood at 33.9% in

[1] *Dorrington RE, Bradshaw D, Laubscher R, Nannan N (2021). Rapid mortality surveillance report 2019 & 2020. Cape Town: South African Medical Research Council. ISBN: 978-1-928340-58-4.*

[2] *https://knoema.com/atlas/South-Africa/topics/Demographics/Age/Life-expectancy-at-age-60-years*

Q2:2022 with an additional 3.6 million being discouraged job seekers.

South Africa has a highly unequal society, with a per-capita expenditure Gini coefficient of 0.67 in 2006, dropping to 0.65 in 2015 (STATSSA, 2020). STATSSA also states that the South African labour market is heavily racialised and gender-biased with female workers earning approximately 30 percent less, on average, than male counterparts, and black Africans also earning the lowest wages when they are employed. The bottom 60 percent of the households depend more on social grants and less on income from the labour market.

According to the 2021 Finscope Survey, 52 percent of the population is in Living Standard Measure (LSM) 5-6, which represents a monthly income level of between R4,165 and R6,322[3] (US$220 and US$334). Most (20.7 million) of the adult population in South Africa are poor, with a household income of less than R43,000 (US$ 2,270) a year. Of the national average, 85.2 percent (35.9 million) of the citizens reported a household income of less than R139,789 (US$ 7,400) per annum. It should, however, be encouraging that of those with a monthly income of less than R1,500 (low-income segment), 5 percent state that they have rainy-day funds for the next 3 months, which also indicates their desire and capacity to save.

Traditional financial inclusion indicators on the usage of branches, ATMs and retail stores were reported to be 12 percent, 57 percent and 25 percent, respectively, at a national level; with usage by the rural poor being 8 percent, 53 percent and 21 percent, respectively. Usage of retail stores was 26 percent nationally and 21 percent by the rural poor in 2021. Of the 29 percent of the individuals who borrowed money over the last 12 months, 16 percent claim to have taken the loan from a retail store. Even though Finscope 2021 states that the use of retail stores for remittances has been declining, nearly half (49%) of adults used retail stores to transfer money while 40 percent received money through a retail store.

[3] *https://repository.up.ac.za/bitstream/handle/2263/25926/02chapter3.pdf?sequence=3&isAllowed=y*

In comparison, only 14 percent of adults sent money using a mobile phone and 13 percent received money through their mobile phones.

Even though most people (48%) seem not to be saving, those that do save usually keep their savings with banks (25%) or in informal instruments (26%). Of those who are saving, 43 percent claim they are saving for food. South Africa's consumers have been feeling the strain, when it comes to items bought most frequently, such as food, transport, electricity, and fuel, since the annual consumer inflation reached a record 13-year high of 7.8 percent in July 2022.[4]

Most of the workforce situated in LSM 5-6 do have some form of formal investment or retirement product and often use either stokvel or savings-clubs or keep cash at home or give it to other family members for safekeeping. Saving through formal retirement products has declined between 2018 and 2021 from 18 percent to 15 percent, with more people save for medium- and short-term needs through informal products, such as keeping cash at home, bank call account and taking up education policies (2021 Finscope Survey). According to STATSSA, 13 million[5] individuals in South Africa are contributing to a retirement fund as a condition of employment.

Whilst the credit active population increased by 4 percent since 2019, more credit active people have been turning to informal borrowing (an increase from 8 percent in 2019 to 20 percent in 2021), with formal borrowing went up from 65 percent to 71 percent during the same period (2021 Finscope Survey).

The Finscope Survey states that 56 percent of adults in South Africa believe funeral insurance is the most important insurance cover. Take up of funeral insurance cover ranks highest amongst lower-income grant recipients, with upper income individuals opting mostly for life insurance. Respondents in the Finscope Survey 2021 indicated that insurance policies offered value for

[4]https://www.statssa.gov.za/?p=15678

[5]STATSSA Quarterly Labour Force Survey, Quarter 2: 2022

money and that the premiums were affordable.

Roughly 91 percent of the national population used a mobile phone in 2021 including some 92 percent of the rural poor, showing flourishing signs of digital and telecom inclusion. Sixty seven percent (67%) of the national population (and 53% of the rural population) are using the internet, mainly for WhatsApp, Facebook, general browsing and accessing emails.

The South African government is currently working on a new biometric digital ID system that would enhance service delivery. This system will replace the current National Population Register, which is used to automatically generate a unique ID number for individuals.

South African interest rates have been consistently higher than in the US or Europe, resulting in domestic bonds outperforming their global counterparts. With 10-year yields at around 10 percent and longer-term inflation expectations still relatively well-contained, the SA Financial Market Journal predicts that investors could have a prospective annual real return above 6 percent over the medium term.[6]

3. BACKDROP TO SOUTH AFRICA'S PENSION REFORM

Retirement reforms are a tedious, hard, and painful process, both locally and globally. The key drivers of pension reforms usually include fiscal pressures, an ageing population, market imperfections, incomplete consumer information and literacy, low savings, investment risks and poor governance measures by those tasked with managing retirement funds.[7]

Reforms in South Africa date back to commissions established just after the new democratic government election, notably the Mouton Commission (1992), Katz Commission (1995), Smith Commission (1995), National Retirement Consultative Forum (1997) and the Taylor Committee (2002). Following these commissions,

[6] *https://financialmarketsjournal.co.za/sa-bonds-offering-attractive-return-prospects/*

[7] *A safer financial sector to serve South Africa better (2011)*

the Government tried to continue with the reforms through an Inter-Departmental Task Team comprising representatives from the departments of Social Development, Labour, Health, Transport, Public Service and Administration, and the National Treasury. The Inter-Departmental Task Team produced the draft Comprehensive Social Security and Retirement Reform discussion paper in 2012, which was later tabled and discussed at the National Economic Development and Labour Council (NEDLAC).

Although South Africa's reform process over the years has focused on broader social security reform, particularly the creation of a National Social Security Fund to fill the gap of a mandatory contributions-based Pillar 2 for all earners, the National Treasury concentrates solely on the reform of the private sector retirement industry. In this respect, the National Treasury has released several papers soliciting views on how best to reform the retirement industry.

South Africa has a wide coverage of retirement provision for those in employment, with STATSSA reporting that 13 million individuals are contributing to a retirement fund as a condition of employment.[8] However, there are still many people lacking effective access to an affordable retirement product. This can be largely attributed to the structure of the economy that has a high rate of unemployment (estimated at 41%), especially among the youth, a large informal sector, and many working-age individuals with periods of unemployment spread throughout their working lives.

In addition to an inconducive economic structure, one could argue that there could be some market failure in the retirement industry resulting in poor coverage and insufficient savings at retirement. According to the School of Oriental and African Studies (SOAS), financial services should, in an ideal world, be provided in an efficient manner as the need arises.[9] However, markets do not always function in a manner desired by free market theorists.

[8]STATSSA Quarterly Labour Force Survey, Quarter 2: 2022. The latest number from the Financial Sector Conduct Authority is around 15 million, excluding the 1.2million members Government Employees Pension Fund.

[9]https://www.soas.ac.uk/cedep-demos/000_P528_RF_K3736-Demo/module/pdfs/p528_unit_01.pdf

Market failures resulting in inefficient allocation of resources have seen many people not being able to access financial services, and these would most often be poor and low-income individuals.

The most pervasive reasons behind market failure in the provision of financial services are opaque transactional costs, unsuitable products, and information asymmetry. Retirement savings products in South Africa are usually provided as a condition of employment. Most of the workers entering such 'quasi-mandatory' savings contracts do so with limited or close to zero information about the retirement fund in which they are being enrolled. As a result, such workers continue to be inactive participants in their retirement funds during their working lives. Some workers may not even be aware that pension contributions are being deducted from their salaries, thereby contributing to the challenge of unclaimed benefits.

Financial markets in South Africa and elsewhere usually tend to serve higher income formally employed persons, leaving low-income non-salaried individuals unserved or underserved. This point is confirmed by the FinScope Survey (2021), which records that most people (48%) appear not to be saving, and those that do save, usually keep their savings with banks (25%) or in informal mechanisms (26%).[10]

As the SOAS also suggests, the high fees and charges of formal finance may be crowding out low-income individuals who can only afford modest savings values. Equally, due to their high transaction costs, product providers are unable to deliver small-ticket financial services to low income individuals in a commercially sustainable manner.[11] This is referred to as the high transaction costs related market failure.

Also, both costs and fees in the retirement savings industry have been found to be opaque, characterised by inequities and non-disclosure, further exacerbated by poor financial literacy.[12] A study

[10] FinScope SA Consumer Survey (fsca.co.za)

[11] https://www.soas.ac.uk/cedep-demos/000_P528_RF_K3736-Demo/module/pdfs/p528_unit_01.pdf

[12] Social security and retirement reform second discussion paper, National Treasury (2007)

by the National Treasury found the adverse impact of recurring charges to be much more significant than initial charges.[13]

Despite a world class retirement industry, and the significant progress in the provision of privately funded "social" insurance for workers in the formal sector of the economy in South Africa, a gap still exists in the extension of social insurance benefits to the informal, contractual, and other atypical workers. As a result of this pension and social insurance coverage gap, coupled with their irregular and uncertain incomes, such excluded workers face a high risk of extreme poverty in their old age.[14] Today, several countries have embarked on efforts to extend pension and social insurance coverage to this cohort of workers. There is, therefore, a need to review the current occupational and private individual retirement coverage in South Africa to better suit those that are excluded. This could even mean moving away from the current rigid employer-linked system to a more universal one.

The approximately 13 million workers that are currently making retirement fund contributions are also facing some challenges in achieving meaningful retirement outcomes. Most of these workers retire without a decent income in retirement, with low replacement rates and a drop in their standard of living due to high levels of leakage. For example, the 2022 Old Mutual Savings and Investment Monitor indicates that less than 6 percent of working South Africans will retire comfortably, with a 75 percent income replacement. According to the Alexander Forbes Member Insights 2021, only 9 percent of members preserved their retirement savings when they changed jobs.[15] Another factor contributing to poor retirement outcomes is the lack of annuitisation at retirement, which has been another form of leakage. Many retirees tend to withdraw (and rapidly consume) a large part of their accumulations as a cash lump sum at retirement, leaving very little with which to take care of their expenses in old age.

[13] *Charges in South African Retirement Funds (2013)*

[14] *DSD ToR Informal Sector Paper*

[15] *https://www.iol.co.za/personal-finance/retirement/compound-interest-is-why-you-must-preserve-your-retirement-savings-3139199f-134d-4399-ab3b-c894ea453544*

To address the various concerns that have been under the spotlight in the retirement savings sector, various legislative and regulatory measures have been, and are being put in place.

The Government and the regulator both recognise that it is best that reforms are built on the positive aspects of the already existing system. This chapter provides an overview of the retirement industry landscape in South Africa and the challenges faced by the current system. We then present the several retirement reforms proposed and introduced to remedy the identified deficiencies spanning over the pre and post Covid-19 pandemic period. Lastly, the critical issue of the uncovered and micro-pensions are briefly assessed as a policy gap that still needs to be addressed.

4. THE SOUTH AFRICAN RETIREMENT FUNDING LANDSCAPE

The Pension Funds Act, 1956, and the Income Tax Act, 1962 provide the legislative basis for the bulk of South Africa's retirement system. All retirement vehicles in South Africa are regulated under these two acts, except for some public and State entity funds that are not subject to the Pension Funds Act, 1956.

South Africa has a well-developed retirement savings industry by international standards. Retirement funds are set up as legal entities, separate from their sponsors and participating employers.[16] Aggregate pension assets amount to 66 percent[17] of GDP and the South African pension system is ranked 27th amongst developed economies.[18] However, approximately 32 percent of the funds have less than 100 members, which adds considerably to the regulatory workload.[19] There are also concerns about the administrative costs and cost efficacy of pension funds with a small number of members. It has been argued that larger funds tend to benefit from economies of scale in administration and are better able to meet regulatory requirements without imposing

[16]https://www.iol.co.za/personal-finance/retirement/compound-interest-is-why-you-must-preserve-your-retirement-savings-3139199f-134d-4399-ab3b-c894ea453544

[17]Charges in South African Retirement Funds (2013)

[18]https://brightafrica.riscura.com/pension-industry/africas-pension-fund-assets/

[19]The Mercer CFA Institute Global Pension Index (2020)

an excessive burden on members.[20] However, Pillay & Fedderke (2021) found evidence indicating that economies of scale do not meaningfully vary with fund size, except for 23-year funds where the optimal fund size was 300,000. Over the years, the industry has voluntarily started consolidating. As per the Government, the number of funds is still on the excessive side, and has therefore mooted the need to further speed up consolidation of retirement funds to a much smaller number, as a way to achieve better economies of scale. Various other countries like the UK and Ireland have also embarked on a similar consolidation process.

Retirement funds in South Africa currently serve nearly 16 million accounts. However, there may be some double counting and the actual number of unique members may be lower as an individual can belong to more than one fund. Nevertheless, with retirement savings forming part of the largest category of savings by individuals in South Africa, it is important to ensure that the retirement system is well functioning, provides good value for money, and therefore better serves the needs of members and beneficiaries. Improving retirement savings provision in South Africa will also require consideration for inclusion of the large proportion of the labour force not yet contributing to any retirement fund. This is equally important for the many African nations whose economies are largely informal.

Despite the seemingly high levels of retirement savings by workers, South Africa is yet to achieve the levels of household savings proposed under the National Development Plan. Savings are important at a personal level to take care of emergencies amongst other reasons. Nationally, it is important to finance investments that are required by firms and the government to buy or build plants, machinery, infrastructure, etc. Retail savings and investments enable the economy to grow and for this to happen, the National Development Plan proposes that the country needs to increase its own national savings from 16 percent to 25 percent of GDP.[21]

[20] With about 68% of active funds having less than 1000 members (FSCA data)

[21] http://www.treasury.gov.za/publications/RetirementReform/Charges%20in%20South%20African%20Retirement%20Funds.pdf

For the retirement savings industry to contribute further to an increase in the country's national savings rate, reforms are needed to tackle the structural deficiencies in the current system. These structural deficiencies were identified as lack of mandatory participation, no preservation pre and post retirement, and too many small funds which can increase costs for members. An assessment of the current retirement funding landscape also suggests that while many workers in the formal sector are contributing to retirement funds, a large proportion achieve insufficient savings mainly because of an erosion of accumulated savings caused by early withdrawals when members change jobs.[22]

Secondly, contributing to a retirement fund is not mandatory for all workers in South Africa as workers participate as a condition of employment. Having retirement reforms focusing mostly on the formally employed sharply separates the formal and informal economies and reinforces this divide. Low-income and self-employed individuals have little to no access to cost-effective and suitable retirement savings vehicles. Further, middle- to higher-income individuals have greater fiscal incentives for retirement savings than low-income individuals because they benefit more from the tax deductibility of contributions and the tax-free lump sums at retirement.[23] Low-income individuals, by contrast, typically face a fiscal disincentive to save through retirement funds because they earn below the tax threshold. For this cohort, matching-contributions by the Government would be both equitable and provide an effective and visible incentive for voluntary retirement savings.

Improving the quality of retirement funding provision also requires reforms to address risks of governance failures in pension funds. A common global regulatory challenge has been the failure by trustees to recognise, disclose and manage conflicts of interest.[24] South Africa has made some progress in strengthening

[21] *Social security and retirement reform paper by National Treasury (2007)*

[22] *Social security and retirement reform paper by National Treasury (2007)*

[23] *Social security and retirement reform paper by National Treasury (2007)*

[24] *Social security and retirement reform paper by National Treasury (2007)*

fund governance through various regulatory interventions. The default regulation on annuity strategy, for example, reinforces member protection by trustees, during both the accumulation and retirement phases, by making explicit the duties of trustees towards members, and by mandating that trustees ensure that funds fulfil their objectives cost effectively.

The purpose of a retirement fund is to produce sufficient income during retirement, disability or for the member's dependants after the member's death. Payment of the full benefit in the form of a lump sum at retirement, as was the case prior to March 2021, when the annuitisation requirement applied only to members of pension funds and retirement annuity funds, and not of provident funds, seldom serves this purpose, especially as people who retire in good health tend to underestimate their longevity. In order to address such post-retirement leakages, policy formulation has favoured the payment of benefits in the form of an annuity or sustained income stream at retirement, unless benefit values fall below a certain threshold.

The consistent approach applied to the payment of retirement benefits across pension, provident and retirement annuity funds was part of a harmonisation of the tax treatment of all forms of retirement funds. The traditional tax regime, that applied differently across different types of funds, made compliance complex for both members and employers, and also made the administration and regulation difficult for authorities.

The next section elaborates the reform journey undertaken to deal with the identified structural and other challenges in South Africa's retirement system.

5. THE PRE-COVID-19 JOURNEY: 2011 - 2019

As much as increased savings would bolster economic growth, there is evidence that savings play an important role in also addressing intergenerational poverty (Searle & Koppe, 2014).

This could particularly benefit a lot of South Africans, given the high rate of unemployment and the increasing prevalence of the "sandwich generation". For example, 39 percent of individuals surveyed through the Old Mutual Savings and Investment Monitor (2022) indicated that they are supporting not only children, but also parents and/ or other older dependents. In order to cultivate a culture that would improve household savings, the South African Government resuscitated the savings and retirement reform process by releasing several discussion papers during between 2012 and 2014. Preceding the retirement reform proposals was the policy document: "A Safer Financial Sector to Serve South Africa Better" released and endorsed by the Cabinet in 2011.

The proposed key retirement reforms sought to achieve the following objectives.

5.1 Encourage Pre-retirement Preservation

For a retirement system to be considered successful, it must provide retirement benefits that enable retirees to maintain a standard of living that is widely considered acceptable. To an extent, this requires adequate funding by the employer and employee throughout the employee's working life. Further, for retirement provision to be adequate, leakages should, as far as possible, be averted. As indicated before, workers currently tend to withdraw their retirement savings as a lump sum when they resign or change jobs, and either rapidly spend these savings, or use them to settle excessive debts. Such leakages do not allow for sufficient growth of savings and also prevent members from accumulating a corpus necessary for a financially secure retirement.

In 2012, in order to address the prevalent high pre-retirement leakage, and ensure that workers have sufficient provision for retirement, the National Treasury released a discussion paper titled *Preservation, portability and governance for Retirement Funds*[25]

[25] *Preservation, portability and governance for retirement funds (2012)*

which proposed the phasing in of preservation of accumulated retirement savings.

This paper discussed the need for retirement benefits to be preserved before and during retirement, coupled with portability. This document put forward a few options on how preservation could be phased in. The first proposal was immediate full preservation with no access to any part of the accumulated retirement savings pre-retirement. The other proposal was to enable some access in the event of certain contingencies. The more pragmatic proposal was to impose preservation on new contributions and on the growth of pension savings accumulated from the date of implementation of the legislation, with certain limited access.

5.2 Encourage Annuitisation at Retirement

The lack of annuitisation at retirement by provident funds, which by their nature paid out cash lump sum benefits at retirement, was one of the leakage concerns and a source of old-age poverty for most members. Payment of cash lump sums, largely means that many retirees spend their retirement benefits too quickly and therefore become vulnerable to old age poverty during their later years in retirement. The requirement to annuitize a portion of benefits in retirement, though later accepted and implemented, was one of the contentious issues with labour unions. Labour unions argued that annuitisation would prevent workers from starting up businesses upon retirement, or from paying off debt, and would instead lock-in workers' savings in private sector pension funds, who would earn more profits using workers' savings. These were tricky political issues to navigate.

This annuitisation requirement introduced for provident fund benefits is similar to that of pension funds and retirement annuity. The proposal to phase in changes to the mode of payment of provident fund benefits included the protection of vested rights for members. This meant that the conversion of a portion of the retirement savings into an income stream at retirement only applied to new contributions made by those who were younger than 55 when the legislation came into effect in March 2021. Further, these new contributions would not need to be annuitized if the total of value of accumulated savings at retirement was R247,500 (~USD13,000) or less ("de minimis rule"). This concession was meant to also address the concerns and consequent opposition of the labour unions to the proposal. Members of provident funds who were 55 years and older as on 01 March, 2021, when the law came into effect, were not affected; i.e. they continued to be governed by the old rule and were not required to convert their provident fund benefit into a pension or annuity.

5.3 Simplify the Taxation of Retirement Contributions

Other than not having the requirement to annuitise provident fund benefits at retirement, contributions from provident fund members did not qualify for a tax deduction. Differential tax deduction rates applied to different retirement funds, with different income bases. This complicated the system. The harmonisation of the tax system of retirement contributions meant that retirement annuity funds, pension funds and provident funds were treated at par from a tax and benefits perspective. This equitable treatment of contributions to all types of retirement funds made the system easier to understand and administer.

The tax harmonisation allowed for a 27.5 percent tax deduction, up to a maximum of R350,000 per annum across all funds. The new tax regime treated contributions to a retirement fund as a taxable fringe benefit for the individual if the mentioned caps were exceeded. However, the additional contributions could still be used in future, or in retirement, to reduce income tax liability. The intention was to make the tax system more progressive, and by limiting the tax deduction to R350,000, vertical equity between high income and low-income taxpayers was improved. Horizontal equity was also improved by harmonising the same deduction across all retirement funds.

5.4 Individual Tax Incentivised Savings Plans

With the intention to cultivate a culture of improved household savings in South Africa, the Government thought it best to cast the net wider than retirement savings, and use taxation as a tool to encourage households to use other available savings instruments as well.

The over-indebtedness of many South Africans signals that South Africans are not saving enough. According to Roets (2021), statistics released by the SA Human Rights Commission shows that over 50 percent of South Africa's credit-active consumers (19 million individuals) are over-indebted. This is being compounded by rising prices of food and transport, retrenchments, and salary cuts because of the Covid-19 pandemic.[26] Also, when individuals do save, it is usually through their retirement funds, which they are able and quick to access when they experience major income or expenditure shocks. South Africans also tend to use retirement savings to pay off debts. The introduction of tax-free savings accounts, which do not attract any tax on interest, dividends, or capital gains upon exit, are meant to encourage discretionary or voluntary savings and thereby supplement retirement savings.

The dispensation to introduce tax-preferred individual savings and investment accounts allows individuals to invest in either interest bearing or equity-based instruments, or in both types of investments, in each account. However, total contributions for the tax year are not to exceed the annual limit, set at R33,000. To discourage unnecessary withdrawals, replacement of withdrawn amounts is not allowed, and a further lifetime limit of R500,000 is also imposed. Institutions licensed as banks and collective investment schemes, including government and registered stockbrokers, are automatically eligible to offer

[26] https://www.news24.com/citypress/voices/covid-19-one-year-on-south-africans-are-heavily-indebted-but-are-looking-at-relief-options-20210325

these tax-free savings accounts. However, products offered are required to comply with the stated principles and characteristics. Requirements include that the products offered as tax-free savings accounts be simple, transparent, and suitable without any contractual contribution obligations (such as insurance contracts) or excessively high early termination charges.

5.5 Encourage Good Value Retirement Products and Services by Reviewing Costs

It would not help much to encourage and require South Africans to save if their savings are largely reduced by high costs and charges. Concerns related to transaction costs, fees and charges are global, and not easy to tackle. With price regulation, such as caps, for financial services and products not generally practiced in South Africa, Governments and the regulators have been deliberately introducing several nudges and using other measures to address the issue of costs and charges. One of the ways the Government is trying to confront the concern on high costs and charges is through driving consolidation of funds, especially focusing on small funds that lack the economies of scale and proper governance measures. Policymakers believe that consolidating and standardising funds could improve both efficiencies and economies of scale.

A paper, titled "Charges in South African Retirement Funds" also released in 2012, presented an overview, based on the information available to the National Treasury, of the current levels of charges during the accumulation phase (i.e., before retirement). This paper also provided an international comparison and examined the drivers of fees and charges.

The paper found that the major determinants of the level of charges are structural – driven by the large number of relatively small retirement funds, and modest account balances, partly because few members preserve savings until retirement.[28] The charging structures were found to be layered and complex – a problem

[27]Charges in South African Retirement Funds (2013)

[28]The top 200 (by asset size) active retirement funds make up at least 90% of the total industry assets.

that was compounded by low levels of required disclosures to members. Further, participation was limited by the lack of a full mandatory system.

To improve the efficiency of the retirement system, the paper proposed that the consolidation of funds be encouraged, fund governance, particularly of umbrella funds, be strengthened, and mandatory participation in a retirement fund be considered for all workers.

5.6 Enhance Governance of Retirement Funds

One means of addressing the concern on the large number of funds, has been a focus on failures by retirement funds to prioritise their ultimate fiduciary responsibility of protecting fund members and the fund. Inextricably linked to member protection is the character and structure of fund governance, and the design and reach of the regulatory regime. Failure to exercise appropriate and sufficiently rigorous standards of fund governance can lead to bad consequences for members who have spent their entire lives contributing to retirement funds.

South Africa relies on trustees (boards of management of funds) to manage and govern retirement funds, with assets worth nearly R3 trillion (R5 trillion if Government Employees Pension Fund is included) as at 2022. It is, therefore, imperative that retirement funds are governed and run by sufficiently trained and skilled trustees, who can avoid or properly manage conflicts of interest, and take decisions which ultimately benefit the members of the funds. The Preservation, Portability and Governance in Retirement Funds paper also touched on governance issues in retirement funds.

This discussion paper found that many trustees may lack the necessary skill to make decisions that are in the best interest of beneficiaries (members), and might be conflicted in discharging their duties to the beneficiaries of the fund.[29] The Government proposed that trustees be statutorily requited to be fit and proper,

[29] Preservation, portability and governance for retirement funds (2012)

with relevant qualifications and expertise in the management of retirement funds. Fraud and bribery have been a particular problem in the investment space. Another challenge is that trustees in South Africa are not pre-vetted before they become trustees, as the system allows for election and appointment of trustees. The labour unions were also concerned that pre-vetting or pre-qualifying trustees could disadvantage certain population groups, given some of the historical discriminatory practices.

To further strengthen governance measures, the Government intended to make the Pension Funds Circular 130 on good governance, which was a voluntary instrument, a legally enforceable regulatory instrument.

In 2018, the Financial Sector Conduct Authority (FSCA) issued the Directive 8, in order to limit such perverse conduct, and deal with governance issues such as gratification and conflict of interest in the retirement funds industry. Further, the role of independent trustees on umbrella funds was strengthened with the issuance of a Guidance Notice in 2018. This informed umbrella funds[30] that they would be exempt from the statutory requirement to have 50 percent of their trustees elected by members, if they had at least 50 percent independent trustees.[31] These interventions limited the potential conflicts and gratifications. They were initially met with resistance from certain players, but were ultimately accepted as good practice.

5.7 Sustainable Finance and Environmental, Social and Governance

South Africa was an early adopter of Environmental, Social and Governance (ESG) investing. The principles of ESG investments were factored in as early as 2013, when the they were first introduced through Regulation 28 by the South African National Treasury. A long history of discrimination, inequality, and reliance on fossil fuel like coal for electricity makes and made South

[30]Umbrella funds are called multi-employer funds or master-trusts in other countries

[31]www.fsca.co.za/Regulatory%20Frameworks/Guidance%20Notes/Guidance%20Notice%204%20of%202018.pdf

Africa a natural candidate to embrace and champion sustainable finance. The Government Employees Pension Fund, South Africa's largest retirement fund, and one of the largest pension funds in Africa, became a founding signatory of the UN Principles of Responsible Investing in 2006.

Principle (2)(c)(ix) in Regulation 28 is worth quoting:

> "Before making an investment in and while invested in an asset, consider any factor which may materially affect the sustainable long-term performance of the asset including, but not limited to, those of an environmental, social and governance character".

ESG factoring is not a competitor or an antithesis to the objective of earning investment returns, and the two can and should be able to co-exist. There is a lingering notion that ESG or sustainable financing will, by nature, mean a compromise of some return. This might be true to a certain extent, and a justifiable outcome if citizens are able to retire in a country and world which is inhabitable, with less natural disasters, less inequality, and more diverse boards and workforces.

Nobody wants to, or should retire in a wasteland or a dysfunctional society.

The pursuit of return at all costs, if assessed now, with a modern prism, is a short-sighted and arguably defective approach to investments as it ignores the externality costs, which in many instances, are not internalised by the companies that pollute, discriminate, or fail because of bad governance.

In 2019, the FSCA followed the revision to Regulation 28 with a Guidance Notice to retirement funds, encouraging them to capture their ESG approach in their investment policy statements, to annually disclose their approach to ESG to all stakeholders, and to report the same in their financial statements. The FSCA

Guidance aligns with the 2019 International Organisation of Pension Supervisors (IOPS) Supervisory Guidelines on the Integration of ESG Factors in the Investment and Risk Management of Pension Funds.

Work is currently underway to update the reporting requirements for retirement funds in line with recent work by the International Financial Reporting Standards (IFRS) on Sustainable Disclosure Standards.

The National Treasury has also been playing a very active role in the sustainable finance space. In 2020, it released an important Technical Paper titled "Financing a Sustainable Economy" and later published an updated version of the same in 2021. This was followed by the SA Green Taxonomy Document in 2022, which is essentially a toolkit and categorisation document that assists investors and investee companies in correctly classifying their investments and activities, and thereby assists in mitigating the phenomenon of greenwashing.

The updated industry-led Responsible Investment and Ownership (RIO) Guide has been issued to assist board members of retirement funds integrate ESG factors into investment decisions, and to empower South African retirement funds to comply with Regulation 28 and Guidance Notice 1 of 2019. In order to ensure that the FSCA and the retirement funds industry have similar capacity building strategies, the FSCA partnered with the International Finance Corporation (IFC) in 2021 for a series of awareness and in-depth training sessions to increase the FSCA's capacity to assess and supervise this complex and fast-moving policy and regulatory area.

South Africa has had its fair share of governance failures, both in the public and private sector. The demise of Steinhoff in 2018 had a direct impact on retirement funds, who prior to the collapse of its share price, held Steinhoff assets worth R25 billion on 1 December 2018, and which fell to R7 billion on 8 December 2018, following the crash. Steinhoff did not have a gender and racially diversified board, and had misrepresented its true financial performance and position in the past – which triggered the collapse of the share price in December 2018. Research has shown that boards that have diverse members, tend to make better decisions. Guidance issued by the FSCA on the requirement that fund boards should in line with King IV governance practices, and have some independent and/or expert trustees, is one way of ensuring this diversity on the board.

Such governance failures have occurred despite South Africa's long history with the long-standing King Code, which was first issued in 1994 and revised in 2016 as King Code IV. It is difficult, if not arguably impossible, to cultivate good governance and ethical leadership in people, especially among older citizens. A lot of fraud happens simply because of unethical leadership, bad governance, inability to control human instincts like greed, and poor internal controls. In many instances, there is a blatant disregard of existing laws and policies of a country and entity. Consequence management, in the form of regulatory and prosecutorial actions, is therefore important. Ultimately, the best preventative remedy would be to raise children to be moral, respect laws and understand the consequences of their actions at an early age.

Aspects of reforms to governance of retirement funds started in 2013, with amendments to the Pension Funds Act, that extended personal liability to employers in respect of non-payment of pension contributions to a pension fund. To further enforce compliance with payment of arrear contributions, which poses a significant challenge in the industry, a Conduct Standard on requirements related to the payment of pension fund contributions was finalised and supported by the FSCA and Parliament in 2022.

To further strengthen the governance of funds by supporting and enhancing trustee competency and skills, the FSCA issued

Conduct Standard No. 4 of 2020 on Minimum Skills and Training for Board Members of Pension Funds. This Standard requires trustees to undergo training, through the FSCA's free online Toolkit, within six months after their election by members or appointment by employers or sponsors.

6. PROGRESS ON IMPLEMENTATION OF THE REFORMS

The persistent process of addressing governance issues was bolstered by the introduction of default regulations, 2017. Although the current law imposes on boards of retirement funds substantial duties to protect the interests of members, in many instances, boards appear to have given insufficient emphasis to simple initiatives that would substantially improve the retirement outcomes of members. To remedy this lapse, it was necessary that the duties of fund boards be clarified to deal with several observed shortcomings.

In many cases, members had been automatically enrolled into excessively complex, unreasonably expensive, or otherwise inappropriate default investment portfolios.[32] Few, if any, fund boards had implemented initiatives to facilitate preservation and portability of retirement savings across funds. The de facto default for most funds was to have retirement balances paid out automatically, in full, and in cash, when members left the employment of the participating employer. Most defined contribution (DC) funds appeared to have ignored their responsibilities to ensure that retiring fund members were able to convert their accumulated savings into an income stream in the most efficient, transparent, and cost-effective manner. While trustees usually helped members make contributions and investments related decisions during the accumulation phase, members were left largely on their own to take decisions about complicated annuity products, which would ultimately determine their income flows over an extended retirement.

[32] *Draft Default Regulations & Explanatory Memo.pdf (treasury.gov.za)*

The default regulations require that trustees assist members during both the accumulation and retirement phases. The intention of the default regulations is to improve the outcomes for members of retirement funds by ensuring that they achieve optimum value for their savings and retire comfortably. The regulations require that trustees offer a default, in-fund preservation arrangement to members who leave the services of a participating employer before retirement, and a default investment portfolio to contributing members who do not exercise any choice regarding how their savings should be invested.

For retiring members, a fund is required to have an in-fund or out-of-fund annuity strategy with annuity options, and can only "default" members who are retiring into a particular annuity product after a member has made a choice. Member defaults need to be relatively simple, cost-effective, and transparent.

The Taxation Law harmonised the taxation of retirement contributions as well as annuitisation by provident fund members. The harmonisation of retirement fund contributions for tax purposes came into effect on 01 March 2016, while the requirement for provident fund annuitisation was implemented in March 2021.

Tax-free savings accounts that were introduced on 01 March 2015 sought to complement retirement savings by ensuring that members would not rely only on their retirement savings, especially in cases of emergencies. It is also expected that pension plan members with money in a tax-free savings account would not need to resign in order to access their retirement savings to cover an unexpected income shortfall or pay off debts.

A 2017 Intellidex study on the tax-free savings account uptake found that 459,848 such accounts had been opened since inception in March 2015, and had resulted in aggregate savings as of R5.2 billion as at 28 February 2017.[33] Most of these accounts were opened with banks (41%), followed by life insurance (27%) and collective investment schemes (21%).

7. GAPS IN THE REFORM PROCESS: ROOM FOR MICRO-PENSIONS

A paper on Comprehensive Social Security and Retirement Reform in South Africa recognises that South Africa has a well-established social assistance programme (Pillar 1) and a robust private pension system (Pillar 3).[34] However, unlike many other middle-income and developed countries, South Africa does not have a mandatory, contributions-based pension system (Pillar 2).

According to this paper, there is a significant gap in the provision of pension arrangements, especially to low-income workers. This is estimated at around 6 million individuals that are not contributing to any retirement fund.[35] The paper further maintains that with low levels of preservation of retirement accumulations, many South African workers are constrained to rely on the State Old Age Grant (SOAG) during their retirement.

Although there is widespread acknowledgement of the importance of savings and long-term insurance, in practice the tendency is for individuals to discount risks and future needs, and to defer saving and investment decisions. These are real behavioural barriers and biases called 'cognitive dissonance' in behavioural economics.[36] Evidence suggests that although workers recognise the importance of retirement provision and state an intention to join a retirement plan or to increase their savings, only a small fraction do so in practice.[37] According to Chybalski & Marcinkiewicz (2018), such behaviour is referred to as myopia and justifies an obligation by the State to participate in a pension system.

Although South Africa has a well-established social assistance programme, and a robust private retirement system, it falls short when it comes to comprehensive retirement savings coverage,

[34]Comprehensive social security in South Africa - Discussion document (unpublished)

[35]Comprehensive social security in South Africa - Discussion document (unpublished)

[36]Blake, D. (2022). Nudges and networks: How to use behavioural economics to improve the life cycle savings-consumption balance. Journal of Risk and Financial Management

[37]Social security and retirement reform paper by National Treasury (2007)

compared to other middle-income and developed countries. Retirement savings provision is usually a basic condition of employment if an employer has a retirement fund. However, there is currently no legislation that makes it compulsory for all employers to provide retirement benefits to workers. This voluntary or quasi-mandatory environment unfortunately means that a large percentage of the working population in South Africa may never have access to a retirement savings option.

Contributing to and being locked-in in a long-term retirement fund may not appear beneficial to most low-income workers. Aka et al. (2016) state that for many low-income earners, contribution to an employment-based retirement plan means reducing consumption or increasing debt. They further argue that low-income workers often do not understand methods of protecting against risk. This, therefore, calls for the need to educate them about the potential long-term benefits from investments and assets that involve risk.

In South Africa, provident funds are a popular fund choice among lower income workers earning below R10,000 (~USD 525) a month. Old Mutual SA Retirement Gauge 2022 states that 86 percent of lower income workers belong to provident funds. These provident funds have a lower contribution compared to pension funds. Lower-income workers earning below R10,000 a month have a lower contribution percentage than those in higher salary bands, likely because this group faces the greatest pressure on take-home pay.[38] This point is affirmed by Aka et al. (2016) who argue that one reason for lower contribution rates among low-income earners is obviously the fact that their daily needs take up a large proportion of their income.

It, therefore, goes without saying that to encourage savings, low-income workers need to be provided with simple, flexible, affordable, and accessible accounts that accommodate small or irregular deposits. It is therefore important to design benefits that might be suitable for this cohort of workers.

[38] *Old Mutual SA retirement Gauge 2022*

Further, the definition of this cohort of workers is complicated. These could be workers that are self-employed and/or employed in the informal economy. According to TrueSouth (2019), the informal sector in the South African case, would most often include workers who do not work for an identifiable employer in the context of an existing employment relationship, implying therefore that there is no employer who could contribute towards retirement or other social security provisioning for these workers.[39]

Poor coverage is layered, with the first layer entailing workers that are formally employed but not contributing to any retirement fund. It is likely that extending retirement coverage to this cohort could be simpler. The second layer or cohort is made up of informal economy workers on whom not much information is available, making it hard for the policy gap to be addressed. According to TrueSouth (2019), one of the key impediments to the development of policy for the workers operating in South Africa's informal economy is a poor understanding of the size, demographic attributes, working conditions, geographical distribution, and income characteristics of this group.[40]

Barriers that explain the virtual nonexistence of pension savings among low-income and independent workers need to be analysed first and possible cost-effective solutions to overcome these barriers need to be explored when investigating the potential of retirement savings to increase social security coverage (Bosch et al., 2019). Further, Bosch et al. found that obstacles to savings include both demand and supply barriers. One of the supply barriers identified is lack of development of long-term savings products that adapt to the needs of vulnerable populations.

As much as it is practical for reforms to be built on the positive aspects of the existing system, a question should be asked if the private sector systems could be adapted to cater to low-income and informal workers with sporadic income streams and potentially small transactions. Given irregular incomes of

[39]*Informal Economy Retirement and Risk Benefits Final Report (2019) (Research commissioned by Department of Social Development)*

[40]*Informal Economy Retirement and Risk Benefits Final Report (2019) (Research commissioned by Department of Social Development)*

non-salaried workers, it would be beneficial also to explore the most practical way of contributing, and an affordable range of contributions, especially as there may be frequent gaps in contributions. It could be that a combination of behavioural nudges, pension systems redesign, and technological innovation is needed to generate an increase in coverage among low income and informal workers. It is worth mentioning that micro-pensions adopted in countries like Kenya, Uganda and Rwanda seem to have made good progress in addressing this complex and tricky gap among this cohort.

The FSCA is also engaging with various stakeholders on the possibility of sandboxing micro-pensions in South Africa. Sandboxing enables appropriate regulatory measures during and after the testing of new and innovative financial products in a "safe zone".

South Africa has been considering the option of a system that includes the establishment of a mandatory national retirement fund. However, work in this area also acknowledges that a mandatory arrangement focuses more on the needs of workers with jobs in the formal economy and is unlikely to work for workers in the informal economy. It is for this reason that the Government highlighted the possibility of a phased approach towards extending coverage to all workers. The view is that auto-enrolment tends to work well for formal salaried employees with the presence of an employer. The first proposed step is therefore to extend coverage to formally employed workers currently not contributing to any retirement fund. The next step could be the informal or vulnerable sector, whereby a more voluntary system backed by tax or other incentives like matching-contributions, and incorporating FinTech which provides user-friendly platforms to enable irregular contributions, and a default fund, could be a possible practical solution.

8. THE POST-COVID 19 JOURNEY: 2020 ONWARDS

8.1 The Covid-19 Impact on Retirement Funds

The advent of Covid-19 was a shock to both the economy and social aspects of life across South Africa and globally. The hard lockdowns resulted in many companies not earning revenues, and therefore paying reduced salaries, or in the worst of cases, not being able to pay salaries at all. This resulted in both companies and employees struggling with contributions to retirement funds because employees were either out of jobs or had to cope with reduced salaries.

A survey undertaken by the FSCA in 2020 revealed that around 47% of the retirement funds had been approached by either the employer or/and employees with a request to reduce or suspend retirement contributions. The impact of Covid-19, in terms of contribution relief requests, was felt strongly in the manufacturing and services industries, and mainly on small businesses. The liquidation of companies resulted in a surge in fund liquidations, which also stretched the FSCA's internal resources in terms of processing liquidation applications.

The equities market experienced a sharp downturn in 2020, with the JSE shedding a third of its value early in that year. The 2020 global and local equities downslide triggered by Covid-19 concerns was one of the sharpest and deepest in the history of market downturns.[41] It was even deeper than the 2008 Global Financial Crisis slump. These sharp losses posed major challenges for members of Defined Contribution (DC) funds, and even more so for those who were on the verge of retirement. Some workers sought to delay their retirement to enable the markets to recover the losses suffered. By late 2020, the JSE had recovered quite remarkably, clearly illustrating the sage advice to savers and investors to not panic and sell-off when markets are volatile. Those who panicked and sold off their investments either because

[41] *https://www.businessinsider.co.za/jse-crashes-2020-3 and TimBukOne*

of rebalancing of portfolios, or opting for early retirement, would have unfortunately locked-in (or permanently suffered) their losses.

To assist with relief measures, the regulator (FSCA) issued Communication 11 in 2020 to the retirement funds industry, informing them of fund rules they could use to suspend or reduce contributions, while they were going through the lockdowns and its devastating aftermath. The Communication also encouraged those funds that did not have such enabling rules, to urgently register them with the FSCA. The influx of rule registrations and amendments posed another challenge for the FSCA as many of its staff were working from home due to the lockdowns. A staff rotation system was implemented, and internal processes adjusted to enable the rules to be quickly registered and signed or stamped later by the FSCA. This agility by the Regulator amidst a crisis was crucial.

These contribution relief measures saved numerous funds from liquidation and thereby helped preserve members' savings. In many instances, the dispensation to suspend or reduce contributions was confined to 6 months, with a maximum of 12 months for some funds, and was conditioned on the employer, employees and the funds agreeing on the terms of the interim relief.

For those who were already in retirement and receiving a "living annuity", the Government also stepped in and changed the regulations to allow annuitants to change their drawdown levels within a limited window of four months (from 01 June to 30 September 2020).[42] Further, the minimum drawdown level was decreased from 2.5 percent to 0.5 percent to enable capital preservation, while the maximum level was increased from 17.5 percent to 20 percent, to enable higher withdrawals.

[42] "Living annuities" are a type of annuity which is not guaranteed. Annuitants are therefore subject to both investment and longevity risk. In other jurisdictions "living annuities" are referred to as "Drawdown Accounts". Their flexibility, however, has made them popular in South Africa compared to typical annuities, which in South Africa are called "life annuities"..

8.2 The Two-Pot System

Covid-19 was a major shock to the incomes and expenditures of households. Breadwinners found themselves having to also support extended family members who had lost jobs. The one positive outcome of Covid-19 is that it forced South Africans to appreciate the importance of saving for emergencies or medium-term goals. According to the 2022 Old Mutual Savings and Investment Monitor Survey, there is higher indication that people are managing to build up reserves, with those who have funds lasting more than 3 months up from 27 percent in 2020 to 39 percent currently.

This income shock, locally and globally, resulted in active members of retirement funds requesting premature access to their retirement savings. Many workers resigned in order to access their entire retirement corpus, which worsened South Africa's already low replacement ratios. It is consistently estimated that not more than 6 percent of working South Africans will retire comfortably, with at least a 75 percent income replacement. As indicated earlier, a major contributor to the much lower replacement ratios that the majority of workers are likely to face, is that South Africa does not have mandatory preservation when members change jobs.

The economic and social shock triggered by Covid-19 forced many Governments and retirement systems to confront difficult questions: Should workers who are financially struggling be allowed to prematurely access their retirement savings? If, however, retirement savings are for retirement, why should they be allowed to be accessed earlier? Can Governments stand aside and let their citizens be destitute now while promising them a good future in the future? These are hard questions.

Saving, especially beyond retirement, is a tricky behavioural science issue and challenge. People suffer from inertia and therefore procrastinate, especially if there is a lot of complex information and complicated decisions to be made. In its negative form, inertia is bad for us as we delay saving until disaster strikes. In certain instances, it can be good for us; for example, the efficacy of proper defaults like auto-enrolment helps us to "make" the right decision by continuing to participate in retirement funds. We also suffer from myopia, which can, in certain instances, also be positively used to nudge the right behaviour like reminding people what Covid-19 did to our lifestyles and how to protect ourselves in the future.

Covid-19 can be approached as a "good" crisis that led to certain critical reforms. In South Africa, the Government positively used this crisis to get important and long overdue concessions with labour unions to introduce mandatory preservation before retirement and upon job changes, while at the same time allowing for some limited early access to retirement savings. This major reform is called the Two-Pot system.

Research shows that workers will be better off in the future if they are required to preserve at least two-thirds of their retirement savings until retirement, compared to the current system where they can resign and access their entire benefits. The system will also obviate the perverse outcome of people resigning to access money from their retirement funds. The proposed Two-Pot system deals with the real behavioural challenge of self-discipline, or lack thereof, by assisting workers to simultaneously save for emergencies or medium-term goals in their one-third pot. By leveraging and expanding on an existing financial product like a retirement fund, the transitioning to this new form of retirement system will enable a seamless and effortless psychological and practical leap; workers don't have to actively do anything, or at least much, to get to higher replacement ratios for their retirement while simultaneously building an emergency fund.

Further, although the Two-Pot system will require some changes to the current administration systems, it should not entail a disruptive overhaul because some of the elements have been in place for many years.[43] Nevertheless, a reasonable transitional

[43]The current system allows a certain amount up to 33% of the retirement savings to be taken as cash at retirement. In a way, the Two-Pot system will be making this existing amount available earlier than at retirement.

period to enable system changes will be important.

The Two-Pot system has been generally well-received by various stakeholders and is expected to come into effect in the next two years following Parliamentary deliberations.

8.3 Prescribed Assets and Infrastructure

Covid-19 also triggered a global discussion by Governments on how best to help their economies to recover. Institutional investors like retirement funds are expected and urged to play an important role in injecting capital into the real economy and in infrastructure. Major Governments like the UK appealed to institutional investors to support the "build back better" initiative, while the US Senate passed the Infrastructure Bill in 2021.

In South Africa, arguably the one and only issue labour unions, the Government and business agreed on was the important role of infrastructure to spur economic recovery. The debate, however, on how best to fund infrastructure was quite animated. Initially there was a strong preference for "prescribed assets" from the ruling party, in the form of a "floor" or minimum to compel retirement funds to invest in Government related instruments. This proposal was always going to be very controversial, given its timing. Despite the more technical, historical, and financial challenges of prescription, for example in compromising returns and weakening market discipline, there was the real and justified issue of "State Capture" and a high trust-deficit between Government and its citizens.

The country has previously experimented with prescribed assets between the 1960s and 1980s. Research shows that by forcing investments into Government bonds and projects, funds consistently compromised better returns earned in equities.[44] Of course, there is a minority who argued that prescribed assets helped to build some of the key public and educational entities in South Africa during the Apartheid years.

[44] *https://hsf.org.za/publications/hsf-briefs/recent-anc-comments-on-prescribed-assets-for-financial-institutions-brief-i-of-ii*

A far better solution to prescribed assets emerged, which proposed that Regulation 28 could be revised to explicitly recognise "infrastructure" as an eligible investment class for pension funds.[45] By explicitly referencing "infrastructure" in Regulation 28, the Government was sending a good signal that infrastructure is also a good asset class which should not be feared by trustees. This approach by the Government was welcomed by society and supported also by the IMF. It was in many respects the right approach as it also underpinned the critical legislated fiduciary duty and freedom conferred upon trustees to always act in the best interest of members of retirement funds while making investment decisions.

A ceiling of 45 percent (with no minimum limit) was set for infrastructure investments, along with a broad definition to include both public and private sector infrastructure, to crowd-in the private sector. In further support of the real economy, the limit for private equity was also increased from 10 to 15 percent, given the important role played by this alternative asset class in infrastructure programmes like renewable energy.

8.4 The Foreign Exchange Exposure Challenge

Capital or exchange controls have been going through a gradual relaxation and reform in South Africa for the last 20 years. Institutional investors in the form of retirement funds and insurance companies (non-market linked business) have been allowed to invest up to 30 percent offshore, with an additional 10 percent for Africa. The 10 percent African allowance was meant to facilitate investments into Africa from and through South Africa. However, this additional Africa allowance was unfortunately not taken up significantly, presumably for many reasons. For instance, Africa still does not have many large, diverse, liquid, and deep exchanges like the JSE, for those investors who prefer the benefits of investing through listed markets. Another reason could simply be lingering Afro-pessimism, from both international and African

[45]Regulation 28 is a prudential assets-spreading instrument for retirement funds which sets only maxima limits for various asset classes

investors; it is hard to ask others to invest in the continent if we as Africans don't have the confidence to do so. African Governments also need to work harder on eradicating corruption, whether real or perceived, build strong institutions, uphold the rule of law, and be transparent and accountable. These issues matter for any investor, irrespective of their nationality.

In light of the above, in 2022 the National Treasury announced further reforms on the foreign allowance by combining the 30 percent "foreign" allowance with the 10 percent African allowance and increasing the overall limit to 45 percent. This higher limit has caused some consternation among certain stakeholders. The new limit should be seen as a long-term limit following on the various reforms in the past undertaken as part of the gradual relaxation of capital controls policy. The merit of this gradual approach cannot be overemphasized as it enables learnings, fulfilment of certain conditions and monitoring of policy impact.

South Africa was an early adopter of this gradual approach and went against the then dominant global sentiment (from advanced countries) and recommendations to remove capital controls immediately or quickly. Even the IMF changed its view and supported the South African gradual approach in 2011.

Will this new, higher limit result in "capital flight" from South Africa? While this is difficult to predict, research has shown that countries like South Africa demonstrate a "home bias".[46] Secondly, experience also shows that excessive foreign exposure can pose prudential risk on entities, and in this case on pension fund members, in the form of currency risk; if you plan to retire in South Africa and the Rand strengthens, your foreign assets will give lower returns. If the Rand weakens, then those foreign assets will deliver higher returns. The Rand is quite a volatile currency.

Geographical risk also needs to be borne in mind, especially noting some of the current geopolitical and economic conditions

[46] *www.treasury.gov.za/documents/national%20budget/2011/CREFSA%20Prudential%20Regulation%20of%20Foreign%20Exposure.pdf*

in the rest of the world such as the Russian-Ukraine war. Foreign exposure is therefore not necessarily an absolute panacea. It is prudent to have some form of protection against excessive risk taking and these foreign limits are common in other countries, although called differently.

Despite some of the risk, real and perceived, foreign diversification is important for a South African retirement fund portfolio. South Africa's markets make up only one percent of global markets. Large companies like Tesla, Microsoft, Google, Apple, are not listed on the JSE. In fact, the JSE is dominated mainly by the top 15 to 20 stocks. Some research and commentary have indicated that an optimal portfolio for a South African retirement fund should at least have foreign assets of between 35 to 44 percent.[47]

Ultimately, the actual exposure will and should be based on each fund's risk appetite, modelling and goals.

8.5 Cryptoassets

The emergence of cryptoassets in recent years has received a lot of global attention from regulators, investors and market participants. These are supposed to be new "asset" classes, but it is not (always) clear what exactly is the underlying asset and their value seems to be driven more by speculation than fundamentals. Their excessive volatility also makes them potentially unsuitable at this stage for retirement funds, especially when in South Africa most members have retirement funds as their only saving vehicle, and noting also that South Africa does not have a mandatory national contributory pillar as a safeguard.

Cryptoassets have also been plagued by scams, resulting in many investors losing their money or not being able to access it when they need it.

It is in this context that South Africa decided in 2022 not to allow retirement funds to invest in cryptoassets, directly or indirectly, at

[47] *open.uct.ac.za/bitstream/handle/11427/8565/thesis_com_2014_com_wepener_cw.pdf?sequence=1&isAllowed=y*

this stage. The decision can potentially be revisited in the distant future when the understanding and regulation of cryptoassets evolve sufficiently enough to make them reasonable or proper investment assets for retirement funds.

9. CONCLUSIONS

This chapter takes stock of the retirement reform journey in South Africa since 2011 to date. Reforms and improvements to the South African retirement industry go beyond protection against income vulnerability in retirement, to related macroeconomic goals for retirement savings which include increasing the national savings rate, with possible positive spill over and multiplier effects on economic growth, employment creation and infrastructure investment.

South Africa has a well-established occupational and individual retirement funding industry that provides protection to many. Much progress has been achieved in the implementation of the proposed reforms albeit, the focus has been on the formally employed and excludes the most vulnerable.

The retirement reform proposals aimed, and still aim to address several anomalies in the private retirement industry to ensure that the industry better serves the needs of members and provides value for money. Reform policies introduced by the Government endeavour to encourage workers to save and provide adequately for retirement to ensure that they retire comfortably and have an income that lasts for most of their lives in retirement. The impact of the preservation and annuitisation requirements that have been introduced would have to be monitored closely to see that the desired effects are realised.

In the process of accumulating savings for retirement provision, the regulatory framework would have to ensure that members get good value for money and are treated fairly, that their savings are prudently and diligently managed, and that they are kept informed of their retirement savings. Supervision and enforcement capacity of the authorities should further contribute to optimal protection of members' and pensioners' interests through the continuous improvement of standards of retirement fund governance, including trustee knowledge and conduct.

For the period ahead, however, there is a great deal of further work to be done in developing a framework for the inclusion of low-income, non-salaried informal workers. Hastening up of studies currently underway on how to appropriately include the low-income and informal workers should be actively considered. The South African labour market is characterised by high levels of unemployment, protracted periods between employment and irregular incomes, and the high number of deaths before retirement. Reforms that seek to extend coverage of retirement and risk benefits to informal sector workers should take cognisance of these factors.

Before applying an approach that is currently being used for formal sector workers, it will be prudent to undertake research to better understand whether and how South Africa's low-income and most vulnerable citizens are presently thinking and preparing for their old age. Such research will also help determine whether the legislative framework, regulations, products and ecosystem currently in place in South Africa can adequately meet the retirement income needs of excluded workers, or whether an alternative strategy is required. For South Africa to achieve more meaningful and comprehensive pension inclusion, and ensure all citizens a secure and dignified retirement, we will need to design systems, products and services that speak to the needs and aspirations of our people.

The journey to reform South Africa's retirement system has been long, hard but fulfilling. It is about make a meaningful contribution to the welfare and lives of South Africans.

Several challenges were confronted; the first major one is around consultation, which require patience, composure and willingness to compromise. Several of the discussions intense as different parties held firm views on certain matters.

The other challenge is what can be termed the “politics of pension”. Of all the financial products offered, only pension funds elicit strong individual and societal emotions, and understandably so because pensions are about individual sacrifices over many years. The workplace nature of pension funds also introduces labour unions and related complex politics in retirement issues and policy discussions. On the other hand, the tax incentives offered by Government justify their strong views on certain matters like preservation and the need to alleviate old-age poverty.

The involvement of these stakeholders requires a careful balancing act, diplomacy, trust and willingness to listen to each other. In a country with a long history of mistrust and misunderstanding between its people, these can make or break well-intended reforms and progress.

The reforms also encountered the classical “principal-agent” problem; it was not always clear, on certain matters, whether parties were representing the desires or interests of their constituencies or more of their leaders or representatives.

At times it is important and good to persist with reforms that are unpopular, on condition that they are well-researched and well-intended, with ultimately good outcomes for society. In most instances people generally oppose new ways of thinking and doing things because they are scared of the unknown. It is therefore important to allow reasonable time for society to understand the benefits and merits of what you are doing and seek to achieve as Government or regulator. The challenge, of course, is that at times you might not have that time.

Lastly, the use of behavioural economics in designing policy and regulatory reforms is indispensable, especially when it comes to pension and broadly savings. People suffer from behavioural barriers and biases, and therefore policy and regulations should be designed to empower and help them make better decisions, or nudge them towards the right action. To achieve this, one needs a very good understanding of how people behave, in reality and most of the time.

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