CHAPTER 9

AN INTRODUCTION TO RETIREMENT FUNDS

Learning Outcomes

When you have completed this chapter you will be able to

- explain what a retirement fund is;
- give a brief overview of the history of the development of retirement funds;
- explain why an employer is usually quite easily convinced to install a retirement fund for his employees;
- discuss the need for negotiations with staff representatives when an employer decides to install a retirement fund;
- explain the differences between a defined benefit and a defined contribution fund and how each of the funds works;
- explain why there has been a major shift in membership from pension to provident funds in South Africa;
- describe the structure, purpose and advantages of a preservation fund;
- explain, in some detail, the eligibility criteria of the Social Assistance Act in South Africa and the benefits provided to persons who qualify.

9.1 ORIGINS AND HISTORY OF RETIREMENT FUNDS

In traditional cultures the elders were considered productive and respected members of society until their death. They were highly valued for their accumulated wisdom, insight and experience. Nobody considered "retiring" them because they were integral to how traditional society functioned. Sure, their roles changed as they aged, but they always had an important role to play.

As industrial society developed people continued working until their health failed. Life spans were simply too short to support an extended period of leisure and there was no mechanism to financially support life without income because no pension system existed. The concept of retirement planning hadn't taken form yet.

All that changed in the early 1900's when social security was created. Shortly thereafter companies and governments began offering pension plans to supplement social security. Around the same time average life spans were beginning to extend beyond 65 years. This combination of factors - increasing longevity and financial programs that provided resources to support a period of leisurely old age, created the first phase of retirement planning.

9.1.1 A DEFINITION OF A RETIREMENT FUND

A retirement fund is a systematic plan set up for a defined group of persons, usually the employees of a business enterprise. The purpose of a retirement fund includes the following:

- primarily to provide a retirement benefit, either as a lump sum, or a regular monthly payment, or a combination of the two options, that will provide an income to a member who has passed the retirement age agreed between the employer and the employee representatives until his death;
- to provide a lump sum payment, or monthly income, to persons who, for reasons such as ill health, are no longer able to remain actively in employment; and
- to provide for the dependants of an employee who might die before he reaches retirement age and, sometimes, even after retirement has been reached, if there are still dependants.

In its simplest form, a retirement fund is a fund of money, or assets, built up by the contributions of the employer and employees over the working lifetime of the employees, in order to provide a retirement benefit for the employee when he reaches retirement age.

There are, however, a number of points in the definition that need to be further explained. These are as follows:

- a retirement fund is usually set up by means of an agreement that is negotiated between an employer and his employees;
- there are exceptions like a retirement annuity fund, as there is no employer involved, but the purpose remains the same; and
- the purpose of any retirement fund is to proide some form of benefit for the members of the fund, or their dependants, when they can no longer earn their own income.

Most funds do not limit benefits to money at retirement but also include other additional features such as an early payment of the benefit as a result of:

- ill health;
- physical disability caused by an accident; or
- death - in which case the benefits will be paid to the dependants of the member until they can take care of themselves. Where the dependants include a surviving spouse the benefits, if paid as a pension, may continue for as long as the survivor lives.

Note that the definition makes mention of the fact that the benefit can be paid as:

- a lump sum; or
- a regular monthly payment; or
- a combination of the two options.

In order to have a clear understanding of the reasons for the different options, you need to know the difference between a provident fund and a pension fund, as well as the different ways that they can be paid to the member.

While a pension and a provident fund are both defined as retirement funds, there is an important difference in the way that benefits can be paid to members at the time of their retirement.

Provident Fund
A provident fund may pay the total value of the accumulated benefits due to the member as a single lump sum. There are a number of factors that may make this option attractive. With a provident fund, once the benefit has been paid to the member, the member has no further claim against the fund. The money paid out to the member will, therefore, have to last him for the rest of his life.

Pension Fund
A pension fund, on the other hand, is not allowed to pay more than $^{1}/_{3}$rd of the accumulated value due to the member as lump sum on retirement. It is only where the value of the accumulated benefit is under R75 000 in total that the lump sum may be paid out as a single amount. The balance of the money **must** be used to purchase an annuity or a preservation fund for the retiree that will provide a monthly income for the rest of his life. The member does not have to take the $^{1}/_{3}$rd in cash, but may use the full value of the benefit to reinvest. This will result in a greater monthly income for the retiree.

A retirement fund is set up in terms of a set of rules that will determine who makes the decisions about:

- structure of the fund;
- the value of contributions; and
- eligibility criteria.

In terms of the Pension Funds Act, a retirement fund must be registered with the Registrar of Pension Funds whose offices are at the Financial Services Board (FSB). The rules must also be approved by the Commissioner for Inland Revenue if tax relief on contributions and benefits is required.

9.1.2 THE HISTORY BEHIND THE DEVELOPMENT OF RETIREMENT FUNDS

When people worked in small groups and communities, the relationship between employee and employer was often close and of a permanent nature. The employer felt morally obliged and responsible for the continued well-being of an employee who could no longer work. In a sense the employee remained part of the community or family, and was provided for by means of a regular salary, even though he was no longer working, that was paid by the employer until the former employee died.

Another early form of retirement provision was that, when an employee retired, a condition of the appointment of his successor was that the successor had to pay a portion of his salary to the retiring employee for as long as that person lived. This system worked satisfactorily, and was practical amongst highly paid employees whose income was more that adequate for their own needs. When an attempt was, however, made to extend such a scheme to the lower paid employees, it became impossible to ensure that payments were made.

These early retirement provisions were most unreliable and unsatisfactory, and so the formal retirement fund was created. In its original form, these funds were financed on a pay-as-you-go principle, so that those on retirement were paid out of contributions being collected from those that were still at work.

The onset of industrialisation and modern medical technology changed all this. There were larger groups of employees working in highly organised industries. Efficiency and productivity became key factors. Employers no longer wanted old, inefficient and unproductive people. The notion of no longer employing people who fell into one of these groups became a fact of life. Employers preferred employing younger, more energetic, people to do the work in order to maintain productivity at a high level.

Sadly, a lot of the older people were left to fend for themselves, or became a burden on their families. Some sympathetic employers did, however, recognise that if an income or annuity, could be provided, the services of the old or infirm could be terminated more readily. As there was, at this stage, no formalised structure of retirement funds, the employer, in order to provide this income or annuity, simply took it out of his profits.

The logic behind the system was that the cost of the retirement benefit could be offset by the overall improvement in efficiency of the business enterprise, due to the replacement of the older employees by younger and more energetic people. This is how the early concept of a retirement payment was born. The problem with this system was that many employers could not maintain these regular payments out of profits when business conditions deteriorated.

A further concern, both amongst employees and the government, was the fact that unscrupulous employers could renege on commitments made to employees, and leave them destitute in their retirement.

It is interesting to note that, as far back as the early 1920's, the State was, in South Africa, already concerning itself with ways and means of supervising the activities of retirement funds. There were two main factors which influenced Government in deciding that some form of control over retirement funds was necessary.

- Firstly, when an employer asks his employees to contribute towards the cost of retirement benefits, or when the employer effectively guarantees a scale of retirement benefits, the employer should set up a form of trust fund which is adequate to meet all claims against the fund as they fall due.

- Secondly, the care and support of the aged was becoming an increasing problem. It was consequently in the interest of government to encourage the establishment of private retirement funds and to ensure, as far as possible, that such funds remained in a position to meet their liabilities.

The question of legislation was raised on many occasions, and so in 1953 the wheels were set in motion. Retirement funds are, today, governed by the Pension Funds Act No 24 of 1956 (as amended), which came into operation on 1 January 1958. All retirement funds must be registered in terms of the Pension Funds Act. While the legislation is called the Pension Funds Act it, in fact, exercises control over all retirement funds, being pension, provident and retirement annuity funds.

At the time of the passing of the Pension Funds Act, **South Africa was the first country in the world** to have a comprehensive Act that controlled such funds. It is interesting to note that some countries still exercise control over their retirement funds through their tax authorities only.

The aim of the Pension Funds Act is to provided for the registration, incorporation, regulation and dissolution of funds. In more basic terms, the Act is there to protect the rights of members, and to ensure minimum solvency standards, to ensure that the fund always has enough assets to meet its liabilities to members.

Within the context of the legislation controlling retirement funds, the Pension Funds Act and the Income Tax Act both have an important role to play. The Pension Funds Act does, however, not concern itself in any way with the tax relief on contributions, the taxation of benefits or the taxation of investments made by the investment manager with the money held within the retirement fund.

9.2 WHY HAVE A RETIREMENT FUND?

Not all employees are members of a retirement fund and, in fact, new funds are being registered every day. With changes in the attitude of employers over the years, the setting up of a retirement fund is also no longer something that is simply done by the employer. Labour relations have come a long way since the early days of sweat-shops and migrant labour, and the employees are now seen as partners of the employer in making the business successful.

Retirement funds are therefore set up after detailed negotiations between the employer and representatives of the employees, to ensure that the best possible benefits are made available for all qualifying members.

9.2.1 TALKING TO THE EMPLOYER

Maslov's hierarchy of needs clearly indicates a higher priority for immediate needs, such as health care and housing, versus deferred needs, such as income during retirement. Communities will, however, differ in their cultural preferences in this regard. The less developed communities would place a high priority on housing, and almost assume that they would be working until their death or, that their children would look after them should they become dependent due to old age.

The more affluent communities, on the other hand, take a house for granted, but aspire for higher level needs, such as being financially able to retire while still at a relatively early age and in good health.

The employer must carefully weigh these preferences amongst the different classes of his employees, if there is an intention to offer a more comprehensive remuneration package, than mere cash wages and salaries.

When approached with a proposal to set up a retirement fund for his employees, an employer who has not yet done so will often use the argument - "I pay my staff well - they must look after themselves". These employers, until they have been convinced to the contrary, believe that employees should put away money during their working lives to ensure that they have sufficient resources available when they are no longer able to work. They also believe that the employees should make their own arrangements to ensure that their dependants are looked after should the employee die an early death.

Some people do save and make provision for dependants, but a great many never appear to reach a stage where they have sufficient disposable income to make adequate provisions. They are probably also not economically conscious enough, and so a structured or systematic savings program set up by either their employer, or the government, is the only way that they will be able to ensure a sufficient income at retirement.

However, apart from the actual and perceived needs of the employees, the employer has a responsibility to consider the future, even though the employees may not be concerned about their retirement needs.

The government has a scheme for the assistance of the aged who have not been able to plan for an adequate retirement income. Unfortunately, other priorities of the government, such as education, housing and the creation of employment, amongst many others, have made it impossible for the government to provide an adequate income for the aged. It does its best with the limited resources at its disposal, but the individual must, as far as possible, make his own arrangements.

Fortunately, employers have generally come to recognise that they have a moral obligation to ensure that their employees are reasonably well looked after in their old age. It is also accepted that it is no longer satisfactory, or sufficient, to reward an employee by making an arrangement at the time that he actually retires.

This is far too intangible and much too dependent on the circumstances at the time. It is generally accepted that proper provision can only be made if money is set aside during the employee's working life, and retained in a separate fund.

As a result, most employers realise that, when the organisation gets to a size where the workforce is becoming a substantial one, usually anything over between about 20 and 50, and the employer can no longer provide retirement benefits out of its own resources, a retirement fund is the only solution.

The employer is, often the instigator of the original negotiations that lead up to the setting up of a retirement fund. Employers, being aware that a happy staff leads to higher productivity, will usually also be more than willing to contribute towards the well-being of the future retired employees, and will, during negotiations, indicate that a portion of the contributions will be paid by the employer.

There are many different cost factors involved in providing the benefits available from the various types of funds, that may be provided by an employer.

The management board of the fund must, however, never forget that the employer is usually the person who pays for the costs of administering the fund, as well as the premiums needed to pay for most, if not all, of the ancillary benefits linked to the fund. Any proposed amendments to benefits, or the rules, that will result in an increased cost will, therefore, have to be negotiated with the employer, in order to determine whether the employer can, or is prepared to, pay for them.

9.3 NEGOTIATIONS WITH STAFF REPRESENTATIVES

South Africa is a country where labour has become a major player in the decision making process. The National Economic, Development and Labour Council (NEDLAC) was created by government with the specific intention of providing a forum where business, labour and government negotiators could mediate on all matters relating to a better understanding between the key role players.

A typical example of the role played by NEDLAC was the lengthy negotiations entered into at the forum before the Labour Relations Act, 1995 was passed through parliament.

If one were to look at the labour unrest linked to the results of the deadlock within NEDLAC between business and labour over the terms and conditions of the Basic Conditions of Employment Bill during 1997, then one can appreciate the power that labour has acquired since the initial creation of the labour union movement in the mid 1970's.This is further evidenced by the strikes held by Government and the Private Sector employees.

The predominance of the Council of South African Trade Unions (COSATU) in the dispute over the Basic Conditions of Employment Act does not mean that they were, or are, the only labour representatives in the country.

An implication of the Labour Relations Act, 1995 was the creation of the need to establish workplace forums, which does not necessarily need any union representation, in any workplace in which an employer employs more than 100 employees.

The unilateral creation of a retirement benefits plan by an employer for his employees is, therefore, unlikely to happen in the current business environment. The employer, having decided that the creation of a retirement benefit plan is in the best interests of both the business enterprise and its employees, will want to deal within a negotiation forum on the structure of the fund.

The first important decision that needs to be addressed is the composition of the employee representative group. The structure of the employee representative group will, to a large extent be determined by the number of employees and their geographic positioning, all staff concentrated in one establishment or divided into branches at all the major centres. Where there is already a large trade union representation it is also only natural that the trade union concerned would wish to be a part of the negotiation team.

With the introduction of Sections 7A to 7E of the Pension Funds Act, any new fund registered after 19 April 1997 must spell out the composition of the management board with its rules and regulations. The initial defining of the management board and the arranging for an election of representatives may possibly be the best solution to the creation of an employee representative body. This body could then negotiate on the benefits to be included in the fund and form the member elected element of the management board.

There is no doubt that the employer and employees will need to have lengthy discussions on the number of representatives on the board. Where many distant branches are involved a resolution regarding representation on their behalf will also need to be resolved. It is also becoming a fairly common practice that trade union representation on the board is determined by the percentage of staff, within the organisation, that they represent.

Should there be a 40% trade union membership amongst the employees and the number of member elected board members set at 5, the trade union would be permitted to appoint 2 of the 5 member elected representatives. Where a fund has been in existence for some time the number of pensioners on the scheme may be large enough for them to be entitled to vote their own representative(s) onto the management board.

The members of the fund are entitled to appoint at least 50% of the board members, in terms of Section 7A of the Pension Funds Act. The employer is entitled to appoint the balance of the board members.

The employer appointed board members must be given a clear mandate within which to negotiate on the position of the employer with regards the provision of benefits and should then enter into the negotiations that will result in the creation of the retirement fund. The employer’s position will no doubt largely be dictated by the cost of any benefits that it will need to bear.

In a retirement fund where the employer has a minimal, or no, funding obligation it is even possible that the management board is made up entirely by member elected representatives, with possibly one or two employer appointed members purely to monitor proceedings. The structuring of the fund and all future decisions would be made entirely by the member representatives. This position is, however, unlikely as it tends to be the norm amongst current retirement fund structures that the employer bears the bulk of the costs of any administration expenses and pays for any ancillary benefits linked to the fund.

9.4 EMPLOYER CONTRIBUTION OPTIONS

The employer's primary contribution option will be a result of whether a defined contribution or a defined benefit fund is selected by the negotiating forum. The employer's representatives will, however, have been given a clear instruction regarding the type of fund preferred by the employer.

9.4.1 DEFINED BENEFIT FUNDS

In a defined benefit fund, the end benefit is fixed in terms of the rules and, in a **pension fund**, is often expressed as a percentage of the member's final salary at the date of retirement.

The end benefit is also fixed in terms of the rules. It is just that the percentage of the member's final salary at the date of retirement, fixed in terms of the rules, will be a far higher percentage, as no further annuity will be paid after the benefit has been paid out to the member. Remember that this is not an interest rate.

When dealing with a defined benefit fund, the second part of the equation is related to either years of membership or service, as defined in the rules of the fund.

To better understand the equation let us look at a simple **example** of:

- a member who is aged 35 at the time that he joins the scheme;
- earns a salary of R4 000 per month (R48 000 per year) at the time of his retirement;
- is entitled to a pension percentage of 2% in terms of the rules of the fund; OR
- in the case of a provident fund a percentage of 20% in terms of the rules; and
- is now retiring at age 65.

To calculate the **pension fund** provision:

if the formula in terms of the rules of the fund states that the pension at retirement will be 2% of final salary for each year of membership then the resultant pension would be:

2% × R4 000 × 30 (being 65 - 35) per month

OR

60% × R4 000 per month

OR

R2 400 per month

To calculate the **provident fund** lump sum:

you must use the annual income of the retiring member. Therefore, if the formula in terms of the rules of the fund states that the provident fund lump sum benefit at retirement will be 20% of final salary for each year of membership then the resultant lump sum would be:

20% × R48 000 × 30 (being 65 - 35)

OR

600% × R48 000

OR

R288 000

Defined benefit retirement plans have to use the services of an actuary to determine the amount of money needed by the fund to pay for the benefits promised in the rules. Once this amount has been worked out, it is converted into the necessary monthly contributions needed to meet the funds future obligations.

At the time that the rules are negotiated, the size of the contribution that will be made by each member is decided. This is normally expressed as a percentage of the salary earned by the member, and will be written into the rules. The actuary will, therefore, be able to establish how much the members will be paying into the fund.

This amount is deducted by the actuary from the total amount needed by the fund, leaving the balance of the cost which is met by the employer’s contributions. Therefore the employer’s contributions become the variable factor in the equation.

With the trend towards defined contribution funds, and the inherent risks that an employer is faced with in running defined benefit funds, **there are very few defined benefit funds still in operation**. Mainly in large corporations do these benefits exist.

9.4.2 DEFINED CONTRIBUTION FUNDS

Defined contribution funds take the same three factors into account, but they are applied in a very different way. The member's contributions are also negotiated and fixed when the rules of the fund are drawn up.

The decision is then written into the rules, usually as a percentage of salary, of say, 5%, 6% or 7%.

The important difference between the two types of funds is that, in a defined contribution fund, the employer’s contributions are usually also fixed in a similar way, although not necessarily on a matching rand for rand basis.

The employer’s contributions may still need to be altered, however, as they are usually subjected to any changes that may be experienced in the costs of administration and the ancillary benefits, costs that are traditionally paid for by the employer.

The impact felt by the employer on the changing costs of administration, and the ancillary benefits included in the retirement fund, will depend, to a large extent, as too whether the fund has an internal or external costing structure.

With an **internal costing structure** the employer's contribution is set at a fixed percentage. All the expenses for administrative costs, and the ancillary benefits, are deducted from the employer's contribution to the fund before the remaining money is handed over to the investment management team.

The danger inherent in this system is the very real possibility that increasing costs caused by, for example:

- increased administration fees; or
- increasing premiums for the ancillary benefits as a result of the aging of the members on the workforce,

may result in the total contribution paid by the employer being inadequate to meet these expenses. This could result in a real erosion of the benefits due to members, as a portion of their own contributions may end up being used to meet expenses.

In order to avoid this situation, a scenario that will be identified when a fund is valued by a valuator, it may be requested of the employer that they increase the level of their contributions or revert to an external costing structure.

With an **external costing structure**, the employer's contribution is set at a fixed percentage, all of which is added to the employee's contributions and handed to the investment management team for investing. The costs of administration and any ancillary benefits that may be incurred by the fund, are treated as an additional expense that is paid by the employer.

The drawback of this system, in the view of the employer, is the fact that the employer's contribution rate is no longer fixed, as is the assumed situation in a fixed contribution fund. Escalating costs of administration and/or ancillary benefits, for the same reasons as were mentioned above, may well result in the employer having to increase its contribution rate beyond the fixed rate negotiated at the inception of the fund.

It must, however, be noted that the very nature of a defined contribution fund, be it internally or externally costed, will make it highly unlikely that the employer's contribution rate will escalate much beyond the rate negotiated at inception. Certainly the risk to the employer of an increase in contributions is far greater with a **defined benefit** fund.

The contributions available for investment, when paid by the employer and the employee, are handed over to the investment management team which invests the money. A record is kept of the contributions made by each individual employee, and the corresponding employer contributions, and this money, together with the interest earned while it is invested, provides a lump sum value at the retirement date of the member.

It can therefore be seen that the value of the retirement benefit received by a member at retirement on a fixed contribution fund becomes the variable factor.

9.4.3 DEFINED CONTRIBUTION VERSUS DEFINED BENEFIT

Whether the retirement arrangement is set up as a defined contribution, or as a defined benefit fund, will depend on the needs of the members and of the employer. While the employer would like to concentrate on his contribution options, the needs of the members, when entering into negotiations at the inception of the fund, will also need to be considered.

The final decision will have to rely on the negotiating abilities of the employer and employee representatives, who need to arrive at a proposed retirement fund with benefits and cost structures that are acceptable to all the parties concerned.

You should not look at the following section as a comparison of the merits and demerits of the two funds, but as a statement of differences.

Negotiations at the inception of the fund will need to take many factors into account before a decision is made on the type of fund to be implemented. A large number of defined benefit funds have, over the last few years, converted to defined contribution funds.

There are a number of reasons why this has occurred.

The differences between a defined contribution and a defined benefit fund must not be seen as a comparison between provident and pension funds. It is possible to have a defined contribution, or defined benefit arrangement, under either a pension or a provident fund.

Some of the important differences between defined contribution and defined benefit funds are that:

- defined contribution funds have an easily calculated member share of the fund;
- defined benefit funds allocate resources according to need. This leads to cross-subsidisation between the members, dependent on their ages;
- the accumulation of the value in a savings account (defined contribution), is more easily appreciated than benefits based on concepts, which are more difficult to understand (defined benefit);
- defined contribution funds can be more flexible about retirement ages without the imposition of early retirement service penalties, since the method automatically has a penalty in that there is less time for benefits to accumulate;
- defined contribution funds tend to provide a stable contribution liability for employers, whereas defined benefit funds usually present an open-ended contribution liability to employers.

The above are some of the reasons that resulted in the demand for, and acceptance of, the conversions from defined benefit to defined contribution funds.

This should not, however, be seen as an indictment against defined benefit funds as, they too, have certain advantages that should not be overlooked:

- the risk of poor investment returns are borne by the member under defined contribution funds; and

- defined contribution funds make retirement planning more complicated, whereas a defined benefit as a percentage or multiple of final salary.

It should be clear that the decision as to which fund is implemented will depend on the needs of the members and the employer.

9.4.4 EMPLOYERS AND SOCIO-ECONOMIC PRESSURES

The emergence of organised labour movements in the 80's, led to a condemnation of pension funds because of the way that benefits were paid to retired members.

Recognising the fact that many employees, particularly those affected by the apartheid laws of the time that would not allow their families to live with them, returned to rural communities upon their retirement, the payment of a monthly pension was deemed to be unsuited to their situation and administratively burdensome.

Members who retired to rural communities, and who were required to collect monthly pension cheques, were faced with a number of difficulties that made the receipt of a lump sum at retirement a lot more attractive.

Many employers were probably not even aware of these problems, but they were, however, very real:

- wealth in rural communities is today, still to a large extent, measured more by the number of cattle, sheep, goats and chickens that you possess than by the amount of money that you have in the bank;

- cultural tradition and personal aspirations meant that many employees aspired towards eventually owning their own home and being able to cultivate the land and build their wealth further, even if only after retirement;

- home addresses of people within rural communities are often stated as c/o the XYZ Trading Store. This store may be as much as a day’s walk away from the home to which the member has retired;

- as there is often no bank within the vicinity of the trading store or post office the trader may charge as much as 20% as a handling fee for cashing in the cheque; and

- the need to transport essential foodstuffs back home may be more than the retiree can manage.

On the other hand, a lump sum payment made at retirement will provide the following solutions to the member who retires back to a rural community:

- the member will return with the means to purchase the cattle, sheep, goats and chickens needed to accord him the status of a wealthy man within the community;

- having the means to purchase the wealth required he will be allotted a tract of land by the local chief on which to build his own home;

- the wives, children and extended family of the returned member will farm the tract of land provided seeing to the need for all the basic foodstuffs that may be required.

This led to labour unrest and a fairly extensive conversion of pension funds into provident funds. The ratio of registered provident to pension funds is approximately 8:1.

It is interesting to note that, with the easing of the movement of people between rural and urban communities as a result of the abolition of apartheid, fewer people are moving back to the rural environments of their birth, and are retiring within urban areas. This is leading to a subtle shift back to a need for an ongoing income after retirement.

9.5 PRESERVATION FUNDS

Before the advent of preservation funds, a person had the following options available on withdrawal before retirement from a pension or provident fund:

- to remain a paid-up member of the employer's fund, if so permitted by the rules;
- to take the withdrawal benefit in cash. Premature access to retirement benefits by a person may lead to the squandering thereof before retirement; or
- to transfer the benefit directly to a retirement annuity fund with no tax consequences. This option precluded any access to the retirement funds before the age of 55.

The general response of the insurance industry to the shortcomings of the aforementioned options was the introduction of pension and provident preservation funds. These have since become entrenched in the legal definitions of the Income Tax Act.

These are pension and provident funds, respectively, to which members of existing pension or provident funds can transfer their accumulated benefits under certain circumstances.

These funds are then available for the preservation and continued growth of the retirement benefits of employees who have withdrawn from their own pension or provident funds. The reasons for this could be:

- as a result of having resigned from their employment; or
- having been retrenched; or
- having been faced with the actual winding up of the pension or provident fund that they may have belonged to.

A person may transfer from a pension fund to a pension preservation fund, or from a provident fund to a provident preservation fund. No provision exists, however, for a direct tax-free transfer from a pension fund to a provident preservation fund.

In the past the employer, with whom the employee was terminating employment, had to become a participating employer in respect of the preservation fund, in order for the employee to be eligible to transfer his benefits to the preservation fund. However, this restriction has subsequently been removed to encourage more open choice.

In essence, the advantages that are enjoyed by a person who transfers from a pension or provident fund to an equivalent preservation fund are as follows:

- no tax liability on transfer;
- one withdrawal from the preservation fund is permitted - either partially or total - prior to retirement age. A member transferring his benefits from a pension or provident fund to an equivalent preservation fund must, however, understand that the total value of benefits due must be transferred. A member who elects to withdraw from a retirement fund and take the benefits as a cash amount, will be able to receive a portion of any withdrawal benefit tax-free, although the sum is limited to an overall ceiling amount from all withdrawals. This tax free concession is currently R22 500. Members have taken advantage of this concession, and instructed the funds from which they have withdrawn that a lump sum amount should be paid to them and the balance transferred to a preservation fund. The revenue authorities have indicated that this will be considered the one withdrawal from the preservation fund, and that no further withdrawal will be allowed;
    - the cash withdrawals allowed in terms of Section 37D will be treated by the Receiver of Revenue as the one withdrawal and the member of the preservation fund will therefore not be allowed to make a further withdrawal until retirement. Where a sum is transferred to a non-member ex-spouse under a divorce agreement, the amount will not count as the member’s one withdrawal.

9.6 BENEFITS PROVIDED BY THE STATE

The Social Assistance Act of 1992 combined all the laws that applied to social aid schemes into one Act. One of the laws that was included was the one that dealt with social old age pensions.

These are now known as social grants. South Africa does not have a contributory national pension fund that can provide social grants to those people that need them. The government does, however, allocate money in the annual budget that will provide benefits to those people who need them from the State’s income on a non-contributory basis.

The amounts of the social grants are looked at every year. Increases in the amounts that are to be paid are normally announced by the Minister of Finance in the annual budget speech. The amounts of social grants are very low - R1 140 p.m.

Social security covers a variety of public and private measures that provide cash and/or benefits in kind, to secure a minimum income for individuals who, due to loss of earnings capacity resulting from illness, disability, old age, retirement, child rearing are left in a vulnerable position.

The Social Assistance Act aligned the State’s position with the fundamental human rights enshrined in the Constitution. It created a single pension delivery system that is non-discriminatory, protects and respects the dignity of all people, and makes information accessible to them.

A person will only be entitled to a social grant if he satisfies the relevant authority that he:

- is an aged or disabled person, or a war veteran. An aged person is defined as person who has, in a case of a woman, attained the age of 60[11] years and in the case of a man, the age of 65 years;
- is resident in the Republic at the time of applying for the grant;
- is a South African citizen; and
- complies with the prescribed conditions.

Non South Africans must have been granted permanent residence status for a five year period.

The prescribed conditions are that:

- he and his spouse pass the means test;
- he does not already receive a social grant; and
- he is not maintained in one of the following institutions run by the State:
  - a prison;
  - a State psychiatric hospital;
  - a State home for the aged;
  - a care and treatment centre; or
  - a treatment centre for drug dependants.

9.6.1 THE MEANS TEST

Social grants are subject to a means test, which takes into account the applicant's income and assets. The means test is designed to ensure that the available funds allocated by government are distributed to elderly South Africans who really need it. Should an applicant's assets exceed the prescribed threshold, he will automatically be disqualified from receiving any benefit.

Single persons are assessed taking into account half the value of their income. A married person is assessed on a quarter of the joint income of the married couple.

Important Information

Where the assets of a single person exceeds 40 times "A", or where the combined assets of a married person and his spouse exceeds 80 times "A" the applicant will not be eligible for a social grant.

"A" is the annually determined maximum level of the social grant which is R1 140 × 12.

11 This was reduced from 65 in 2008, and again reduced to 61 in 2009, effectively bringing in equality with the provision for females.

In calculating how much money a person has, as part of the means test, the following is considered:

- all the applicant's assets, other than his house, are taken into account at market value;

- incomes from all sources are considered. This includes any income earned on the assets that make up the value of the above threshold. Once the level of income from all sources has been determined, 50% of this is deducted from the value of the social grant currently being provided;

- money earned from any kind of work, after contributions to unemployment insurance, medical aid, a staff retirement fund and tax is taken off;

- where the spouse of an applicant is working then a quarter of that spouse's earnings are taken into account as income of the applicant.

However, if the income of the applicant's spouse is a pension or other grant, that pension or grant will not be counted as income received by the applicant.

Should the value of the grant due to the claimant exceed R100 per month the grant will be paid to the claimant. No grant that works out to less than R100 per month will be paid.

Where a husband and wife are over 60 years old, and both are not working, they can both apply for full grants.

The welfare officer, who will be charged with calculating whether a person is entitled to a full grant, partial grant, or no grant at all, will take the following **kinds of income** into account:

- money a person receives from a private pension fund;

- money from rent paid by lodgers in the house, even if the lodgers are members of the pensioner's family, gifts of money sent to the person applying are also counted as income;

- the value of a house owned by the person who is applying for the grant, if the person does not live in that house. So if the person owns two houses, then the value of the house that he does not live in is counted as income; and

- money earned from growing crops or owning livestock.

9.6.2 KINDS OF GRANTS

(a) Old age grants
Payable to women who are 60 years of age and older, and to men who are 65 years of age and older, all of whom will be subject to the means test before their grants are approved.

(b) Grant-in-aid allowance
If the physical or mental condition of a person who is getting a social grant is so bad that he needs to be looked after all the time an additional amount per month may be paid. When this extra allowance is applied for a medical certificate must be sent with the application. (R260 per month as from 2011)

(c) War veterans

Anyone who was in any military, naval or air service during the wars that South Africans have fought in can apply for a war veteran grant when they reach the age of 60 years or older if they are unable to maintain themselves because of a mental or physical disability caused by the wars.

All people that apply will have to qualify with the means test. The war veteran's grant is slightly larger than the amount received as a normal social grant. War veterans applying for their grant must submit their discharge certificates. (R1 160 per month as from 2011)

(d) Disabled persons

The grants are paid to people who are 18 and older, who are disabled for six months and more who cannot support themselves because of the nature of their disability. (R1 140 per month as from 2011)

(e) Foster child

Persons who act as foster parents for children who have been taken away from their parents for their own safety or children who have been orphaned and need special care that cannot be provided by an orphanage (for example, new-born babies) can claim a special social grant for every child in their foster care. The appointment as a foster parent must be ratified in court and the foster parent will have to qualify for the grant in terms of the means test. (R740 per month as from 2011)

(f) Child support

A primary care giver who cares for a child or children (up to a maximum of six children) who are under the age of eighteen can apply for a special child-support grant. (R270 per month as from 2011.)

9.6.3 MEDICAL FEES

Persons who qualify for a social grant will **not** have their medical fees paid, but may qualify for free medical care. They must ask their local Magistrate for the details. Persons on social grants can also go to Provincial hospitals, where they will be given free medical and dental care.

Provided as background information only

Payments of grants

Grants are paid once a month. A foster child grant is paid from the date of the court order, when the child is placed into the custody of the foster parent(s). For all the other grants the money is paid from the original date of application, once the grant has been approved.

Ways of getting paid

When applying for a grant the officer assisting the applicant should be able to recommend the best way as to where and when the grant is to be received.

- Some people get paid at the Post Office.
- Others ask for the money to go straight into their bank account.
- Still others get paid in cash, with their money paid to them by a clerk. A bar coded ID book as proof of identity is needed for this method of payment.
- A fairly new innovation in South Africa is the payment as cash at an electronic pay-point. The recipient places his hand on a screen, or inserts a card into a slot, and is then told the value of the grant due to them. On withdrawal, the recipient will be issued with a slip showing how much has been paid. Should the money not be there, the slip will state this and give the reasons why.
- Others get paid by cheque. This is especially true in the Eastern Cape.

9.7 TOWARDS A GOVERNMENT PENSION FUND IN SOUTH AFRICA

In his 2007 budget speech Finance Minister Trevor Manuel announced that Government is considering a social security system that would make it compulsory for all working people to save a proportion of their income for their retirement, but would guarantee that everyone received at least a minimum monthly pension.

The idea is to make it affordable and worthwhile, even for low-income earners, to save for their retirement. The new system would guarantee that everyone received at least a minimum monthly pension, as well as death, disability and unemployment benefits.

The targeted income range is up to R60 000 per annum, with compulsory contribution rates of up to 15% or 18% and allowance for voluntary additional contributions. A form of cross-subsidy is envisaged for low income earners - R5 000 p.a. for those earning under R15 000 and a sliding scale of reduced subsidy up to R45 000 p.a.

The model on the table is effectively a combination of a defined contribution fund with an underlying defined benefit content aimed at 40% of salary, up to the threshold level.

Any such initiative could have major implications for SA's long term insurance industry. Depending on how it is designed, a new system could compete with the private sector or it could complement it, bringing millions more people into low-cost retirement fund arrangements that could be managed by existing industry players.

Work on the proposed social security scheme is understood to be the main factor delaying the completion of the national treasury's long-awaited retirement fund reform proposals. The treasury released a discussion paper on retirement fund reform in December 2004, promising to revise the proposals in response to public comment, but nothing has emerged.

The 2004 discussion document proposed creating a new national savings fund that would provide an affordable retirement savings vehicle for low-income earners, particularly part-time and seasonal workers, those in the informal sector, and domestic workers. But the current thinking goes beyond that, suggesting a compulsory system that would cover employees at all income levels.

The social development department has also been working for some time on proposals for a contributory social security system, but the department and the national treasury are said to favour different approaches.

Although SA has a highly developed private retirement fund industry, with many companies making a pension or provident fund a condition of employment, millions of employees are still not in the net. The Human Sciences Research Council's Miriam Altman estimates that only 55% - 60% of the formal sector workforce, or only 29% of SA's total labour force, is covered by private pension plans.

A key reason Government is looking at a contributory scheme is that the existing system of social grants, on one hand, and tax incentives on the other, create a disincentive for low-income workers to save for retirement. The State old-age pension is subject to a means test, so that most of those who receive private sector pensions, even small ones, are not eligible for the grant. At the same time, the tax incentives to contribute to pension or provident funds are worthless for the millions of low-income earners, who fall below the tax threshold.

The idea of a national fund is also partly a response to the concerns about the cost of private sector pension plans that have been raised in the past, as well as about regulatory issues that have arisen, as a result of the pension fund adjudicator's series of recent rulings against retirement annuity and pension providers.

It is thought that a compulsory, State-driven fund would benefit from economies of scale that would bring down the cost of pension provision, as well as from spreading the risk among more savers. The scheme could be similar to SA's unemployment insurance system, in that everyone would contribute a percentage of their earnings up to a certain level, and would receive benefits in line with their pre-retirement incomes.

Social old age pensioners would not be covered by the new law, as they were already fairly well covered by the payments system provided by the government.

The emphasis in the discussion paper was on those people in informal or irregular employment. They usually have no way of saving for their old age, unless they set aside funds themselves in a retirement annuity policy. The discussion paper also looked at those in formal employment, who pay into a pension fund as part of their employment contract.

But many issues remained unresolved, to which no one has the perfect answer. These include whether pension payouts should be made in the form of lump sums, or by conversion into monthly income after retirement.

There is still extensive consultation required on the plan, according to officials of the treasury and the social development departments. In fact, some commentators are suggesting that 2015 may be a more realistic implementation date.

There is pressure to include a health insurance component, in line with the priority the African National Congress is giving to health and education after its Polokwane conference. It is also being said that the global financial meltdown of 2008 may well result in a lowering of the initial benefits. This has added complexity and cost to the social security framework.

It has been suggested that trade unions might oppose the setting up of a national social security fund, that might displace the existing pension and provident funds that serve their members.

It is not clear yet whether the proposed national fund will be a default fund - collecting savings and providing retirement benefits and social insurance only for those who do not already have their own funds - or will replace existing funds.

The current retirement fund landscape is highly fragmented, with about 13 500 funds, more than 80% of which have fewer than 100 members. The Government is keen to see consolidation and better regulation of the sector. But it could allow accredited funds to opt out of the national fund.

QUESTIONS ON CHAPTER 9

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Mental revision questions

Work through these mental revision questions as a test of your understanding of this chapter. We suggest that you attempt these before tackling the written questions. Please note that suggested answers are not provided as the chapter's text contains the answers.

1. Define a retirement fund.

2. Who must approve and accept the rules of a retirement fund?

3. At what stage should an employer consider the possibility that his staff is getting to big and he should consider a retirement fund?

4. Why do registrations of provident funds in South Africa exceed those of pension funds by 8:1?

5. What were the options available to a member who withdrew from a retirement fund before the advent of preservation funds?

6. Beyond what level of assets owned does a person not qualify for social assistance?

7. What is the maximum benefit that may be due to a war veteran under the Social Assistance Act?

Written questions

Attempt these questions after you have completed this chapter and its mental revision questions. Suggested answers to these questions are at the end of this book.

1. The South African Government felt a need to involve themselves with the regulation of retirement funds. Discuss the advantages and disadvantages of this move from the point of view of:
   1.1 the employee;
   1.2 the employer;
   1.3 the well-being of South Africa as a whole.

2. Explain why an employer should not ignore the feelings and opinions of organised labour when deciding to implement a retirement fund. What problems would you perceive in holding discussions with staff representatives?

3. A member who is earning a salary of R7 500 per month and has 22 years service is retiring at age 65. The defined benefit fund allows 2% for every year of service.
   3.1 What would be his pension if he decided to take the maximum amount permitted as a lump sum?
   3.2 Under what circumstances would you consider this to be sufficient retirement savings and why?

4. How does a preservation fund work? What are the advantages and disadvantages to an individual in transferring the withdrawal amount from a pension fund to a preservation fund as opposed to purchasing a lump sum retirement annuity with the amount?

5. List and describe the special grants payable under the Social Assistance Act.