Career Ready Academy

TEXTBOOK

Pension Products

Final Module for COB 4

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INTRODUCTION

An FSP must ensure that it, its key individuals and representatives are proficient in respect of, understand, and have completed adequate and appropriate class of business training and product specific training relevant to, the particular financial products in respect of which they render financial services or manages or oversees the rendering of financial services.

Class of business training, where appropriate must include training on the following:

The range of financial products within the class of business.

The general characteristics, terms and features of financial products in the class of business and any specialist characteristics, terms and features in respect of financial products in the class of business.

The typical fee structures, charges and other costs associated with products in the class of business.

General risk associated with investing, purchasing or transacting in the products in the class of business.

Investment and risk principles, options and strategies in respect of products in the class of business.

The appropriateness of different products or product features in the class of business for different types of clients or group of clients.

The typical role players or market participants in respect of products in the class of business, including their legal structure.

The impact of applicable legislation, including taxation laws, on product in the class of business.

The impact of applicable economic and environmental factors on the products in the class of business and the performance of those products including:

- The economic and business environment and cycles.
- Inflation.
- Government monetary and fiscal policy.
- Interest rates and exchange rates.

Any inter-relationship within and between particular classes of business.

Industry standards and codes of conduct relevant to class of business

This module is the final module in order to be certified for COB Class 4: Pension fund benefits.

To be certified, complete all of the required modules:

- COB General Module: All Classes of Business
- COB Intermediate Module: Class 3, 4, 6, 7 & 8
- COB Final Module: Class 4

Topic 1 Overview Of Retirement Fund Industry

LEARNING OUTCOMES

After studying the topic, the learner should be able to-

- Outline the legislation that has an affect on the retirement fund industry.
- Provide an overview of the planned retirement reform.

1.1 INTRODUCTION

Individuals in South Africa usually make use of some kind of retirement fund at some stage in their life to provide for themselves once they have retired.

In their simplest form, retirement funds are non-profit institutions that collect, invest and administer monies contributed to them by individuals and companies. In other words, retirement funds are regulated savings pools that enable people to save cost and tax efficiently for old age.

Many employers provide pension or provident funds for their employees, while self-employed persons might become members in a retirement annuity fund by purchasing a retirement annuity policy from a life insurer.

Preservation pension and provident funds do not accept contributions from members or employers directly but receive members' benefits transferred from pension and provident funds when the members of those funds elect to leave these funds and want to save/preserve their benefits until a later date or event, for example, retirement.

Individuals can use other investment products in order to save for retirement including the following:

- ☐ Unit trusts
- ☐ Fixed deposit accounts
- ☐ Money market accounts
- ☐ Endowment policies
- ☐ Government retails bonds
- ☐ Equity investments

Should an individual not have any retirement or minimal retirement savings, they can make use of the state old-age pension. The state old-age pension also known as the older person's grant is a minimal monthly income for South African citizens or permanent refugees 60 years or older who have a monthly income below a certain level.

This is merely to serve as an introduction as this module will focus on group employer sponsored retirement funds which forms part of Class of Business 5: Pension Funds.

1.2 LEGISLATIVE ENVIRONMENT

Considering the importance of retirement fund benefits to the citizens in enabling them to support themselves and to continue to maintain a decent standard of living on retirement, the state has deemed it necessary to enact legislation that protects the members' fund set aside for this reason.

All retirement funds must be registered in terms of the Pension Funds Act. Once registered a fund becomes a separate legal entity from the employer, with both employers and members having obligations to the fund. A major benefit of a fund separate from the employer is that members' accrued benefits are secured and are thus not dependant on the solvency of the employer.

A retirement fund is subject to the basic principles of the common law of trusts. This law specifies important codes of conduct relating to the behaviour of the board of trustees: the people elected by the members and appointed by the employer to be in charge of managing the trust.

Further to this, retirement funds are governed by various other pieces of legislation. The subsections following provide an overview of the most important legislations that have an impact on the governance of retirement funds in South Africa:

- ☐ The Pension Funds Act
- ☐ The Income Tax Act
- ☐ The Financial Institutions (Protection of Funds) Act
- ☐ The Long-Term Insurance Act
- ☐ The labour relations Act
- ☐ Divorce Act

1.2.1 Pension Funds Act, 1956 (Act 24 Of 1956)

The main source of legislation for pension and provident funds in South Africa is the Pension Funds Act, which has been amended on various occasions.

The legislation covers a wide area of potential sources of risk and acknowledges that in many cases there are 40 or more years between when the monies are invested, and the benefits are received. The legislation requires the ongoing regulation and oversight of retirement funds to protect the members' interests.

The Pension Funds Act also stipulates that retirement funds need to maintain ongoing solvency and regulates how this solvency must be demonstrated.

The Pension Funds Act is, therefore, the main piece of legislation in terms of which pension fund organisations are regulated and their legal status determined. The term pension fund organisation includes any type of retirement fund, namely a pension fund, provident fund, retirement annuity fund, pension preservation fund and provident preservation fund. No distinction is made between these types of funds in the Pension Funds Act, as all funds are treated as pension funds for the purposes of the Pension Funds Act. However, separate definitions of these funds fall under the Income Tax Act.

I) Registration Of Pension Funds

No fund is allowed to conduct the business of a pension fund unless it has been registered by the Financial Sector Conduct Authority as such.

The most important reason for registration is that a registered pension fund becomes a separate entity in law quite apart from the employer and the employees or indeed from any other person directly or indirectly connectedwith the fund. So, if a member of a fund is made bankrupt, his retirement fund assets are protected in full against creditors, so that they cannot be attached. Equally, should an employer go into liquidation, creditors cannot be reimbursed from fund assets.

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Compliance of retirement funds with the Pension Funds Act is continuous. If a fund does not comply with the requirements and responsibilities prescribed in the Pension Funds Act registration may be withdrawn and the fund would have to be liquidated.

II) Objective Of The Pension Funds Act

The objectives of the Pension Funds Act are as following:

- ☐ To provide for the registration, incorporation, regulation and dissolution of retirement funds.
- ☐ To protect the rights of members.
- ☐ To ensure minimum solvency standards for retirement funds.

III) Pension Fund Rules

At its simplest, the establishment of fund creates a contract between the employer and the employees. The documentation reflecting the terms and conditions that the fund will operate under is called the rules.

Each fund needs to formulate its own set of rules. These rules must conform to the requirements of the Pension Funds Act and be approved and registered by the Commissioner and the South African Revenue Services.

The rules of the fund should at least cover the following areas:

- ☐ Name of the fund.
- ☐ Objective of the fund.
- ☐ Requirement for membership.
- ☐ Circumstances under which membership will cease.
- ☐ Circumstances under which members or beneficiaries will become entitled to benefits.
- ☐ Nature of benefits provided by the fund.
- ☐ The default regulations.
- ☐ The benefits payable on the following:
    - ▪ Normal retirement.
    - ▪ Early retirement.
    - ▪ Ill-health retirement.
    - ▪ Death before retirement.
    - ▪ Resignation.
    - ▪ Dismissal.
    - ▪ Retrenchment and redundancy.
    - ▪ Late retirement.
    - ▪ Deferred benefits.
    - ▪ Death after retirement.
- ☐ Process to be followed in appointing the fund’s officers, such as trustees and principal officer.
- ☐ Process to be followed in removing the fund’s officers.
- ☐ Process to be followed in changing the fund’s rules.

- ☐ Appointment of an auditor.
- ☐ Method to be followed in settling disputes.
- ☐ Custody of securities owned by the fund.
- ☐ How the fund may be terminated or dissolved.
- ☐ Appointment of a liquidator if required.
- ☐ How rules may be changed
- ☐ The appointment of an auditor
- ☐ Resolution of disputes between the fund and its members
- ☐ Termination of the fund either totally or partially
- ☐ Possible transfer to or amalgamation with another fund
- ☐ How unclaimed benefits are to be dealt with
- ☐ Establishment of a bank account (where needed)
- ☐ A commitment that a fidelity guarantee policy will be affected.

Where a fund is established for a single employer, the rules usually follow a narrative layout.

Where the fund is an umbrella fund set up for multiple employers who are usually quite independent of each other, the format consists of a basic set of rules, known as general rules, together with another set of rules, called special rules.

The reason for the division is that the umbrella fund will have conditions, which will apply across all participations, but certain features must be adapted to meet the needs of each individual participating employer. For example, retirement ages will differ between participating employers, and there will be differing criteria as to which staff may join.

This is done as the cost of registering a full set of rules for each participation is considerably more than registering a set of general rules once only, and then adding special rules as each new participation joins.

IV) The Default Regulations

The Minister of Finance issued the Default Regulations with effect from 1 September 2017. The Default Regulations prescribe conditions for default investment portfolios, default preservation and portability, and annuity strategies for funds.

All new default arrangements that came into operation on or after 1 September 2017 must comply with the requirements set out in the Default Regulations. Existing default arrangements must be fully aligned to the Default Regulations by 1 March 2019 and the Financial Sector Conduct Authority will examine funds' compliance with the Default Regulations from 1 March 2019.

The default regulations are summarised as follows but considered in greater detail later:

- ☐ **Regulation 37:** The board of trustees of a fund must offer a default investment portfolio to contributing members who do not exercise any choice regarding how their savings should be invested.
- ☐ **Regulation 38:** The board of trustees of a fund must offer a default in-fund preservation arrangement to members who leave the services of the participating employer before retirement.
- ☐ **Regulation 39:** For retiring members, a fund must have an annuity strategy with annuity options, either in-fund or out-of-fund and can only default retiring members into a particular annuity product after a member has made a choice.

V) Regulation 28

This regulation (also referred to as prudential investment guidelines or PIGs) stipulates the maximum exposure that a fund can have to each type of investment asset class. These guidelines have been laid down to limit the investment risk that retirement funds can take on. As with many of the regulations, these are reviewed from time to time, but a brief summary of current regulations is provided in the table following.

Table 1.1: Withdrawal benefits table

Assets (percentages in brackets are sublimit)	Maximum percentage of total fair value of fund assets
Listed shares	75%
Unlisted ordinary and preference shares	10%
Cash (SA)	Unlimited
Government bonds (SA)	Unlimited
Debt guaranteed by a South African bank	75%
Other corporate debt listed (25%) or unlisted (15%)	25%
Listed (25%) and unlisted (15%) property	25%
Commodities	10%
Hedge funds (10%), private equity funds (10%) and other assets (2,5%)	15%

The use of unit trusts and life insurance policies as investments is quite common in South Africa, especially by smaller retirement funds. Regulation 28 allows the use of these investment vehicles, but on the basis that the underlying investments conform to the regulations. This is why one often sees unit trusts marketed as approved in terms of the Pension Funds Act or complies with prudential investment guidelines.

1.2.2 The Income Tax Act, 1962 (Act 52 of 1962)

Benefit payments from and contribution to a pension, provident or retirement annuity fund is subject to the provisions of the Income Tax Act.

After the rules of a retirement fund have been registered, they are sent to the Commissioner of Inland Revenue for tax approval. As with the Pension Funds Act, the rules of a fund must include certain provisions that impact on its structure, without which approval will not be received.

If a retirement fund contravenes the provisions of the Income Tax Act, it may lose its approval status, which would have an impact on the employer and members.

The tax implications for retirement funds and benefits will be considered in a later topic.

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1.2.3 Financial Institutions (protection of funds) Act, 2011 (Act 28 of 2001)

The Financial Institutions (Protection of funds) Act deals with the duties and obligations of financial institutions (including retirement funds, insurers and fund asset managers) relating to the investment, safe custody and administration of funds and trust property, as well as powers given to the Commissioner to protect such funds and trust property.

The duties expected of fund trustees imposed by this Act, includes the following:

- Declaring interests and avoiding conflicts
- Acting with due care and observing utmost good faith
- Prohibiting use of fund assets for personal gain
- Requiring investments to be made and managed in accordance with the investment mandate
- Ensuring that assets are held in a fiduciary capacity in a separate account in the name of the fund.

1.2.4 The Long-Term Insurance Act, 1998 (Act 52 of 1998)

A long-term insurer plays an active part in the provision of services to retirement funds. The definitions within the Long-Term Insurance Act allow an insurer the opportunity to provide the benefits due to the members of a retirement fund on behalf of the registered fund.

Another option used by insurers, based on this definition, is the provision of individual retirement fund benefits to the members of a registered retirement annuity fund. Retirement annuity funds abide by this definition in that they do not sell individual policies to the people who want their own retirement annuity. The individuals all become members of the fund, which has been set up for the group as a whole by the insurer.

Insurers also offer the service of administering retirement funds.

An insurer granted a general licence will be in a position to do business in all the categories of long-term insurance. Such a classification is defined as long-term business. Restricted licences are issued for the following classes of long-term insurance business:

- Assistance policies
- Disability policies
- Fund policies
- Health policies
- Life policies

The Long-term Insurance Act and the Pension Funds Act thus have many similarities in terms of controls and being monitored. In one area there is, however, a very fundamental difference. Whereas the Pension Funds Act deals exclusively with benefits provided to groups of people, this is only one of the areas within which long-term insurers operate. They are, in fact, far better known for the fact that they can provide benefits to individuals, who can also become the owners of the policies they choose to purchase. There are thus certain unique aspects of long-term insurance business of which you need to be aware.

Retirement benefits paid in the event of the death of a member are protected from creditors in terms of Section 37B of the Pension Funds Act. While there are certain exceptions, most of the benefits are usually protected. This is not necessarily so with a long-term insurance policy. While the Long-term Insurance Act certainly affords some protection to long-term policies, this is by no means as extensive as that offered by the Pension Funds Act.

1.2.5 The Labour Relations Act, 1965 (Act 66 Of 1995)

One of the primary purposes of the Labour Relations Act was to give effect to Section 23 of the Constitution of the Republic of South Africa, 1996. Section 23 forms a part of Topic 2 that deals with the entrenched fundamental Bill of Rights contained in the Constitution.

Section 23 bestows rights on workers, employers, trade unions and employers' organisations.

Every worker has the right to form or join a trade union, participate in the activities and programs of a trade union and strike.

Every employer has the right to form and join an employers' organisation and to participate in the activities and programs of an employers' organisation.

Every trade union and employers' organisation have the right to determine its own administration, programs and activities and organise, form and join a federation.

Every trade union, employers' organisation and employer have the right to engage in collective bargaining. National legislation may be enacted to regulate collective bargaining.

National legislation may recognise union security arrangements contained in collective agreements. To the extent that the legislation may limit a right in this topic, the limitation must comply with Section 36(1) of the Labour Relations Act.

The most important aspect of the Labour Relations Act, however, from the perspective of persons involved in the management and administration of a retirement fund, is employee benefit arrangements and in the dispute resolution procedures. The Labour Relations Act plays an important role in this regard where the dispute is lodged against the employer and/or the fund on the basis of an unfair labour practice.

I) Employee Benefit Arrangement

An employee benefit arrangement refers to a benefit provided to an employee by an employer in addition to normal salary or wages. Employee benefits include retirement fund arrangements for example, pension or provident funds.

The aim of employee benefits is to increase the financial security of employees, especially in the case of retirement, death or disablement of the employee. This has given rise to employers offering employees a formal, disciplined savings vehicle in the form of membership of a pension or provident fund.

The implications of the Labour Relations Act are that an employer, in deciding on the benefits to be including in a pension or provident fund for its employees, the employers must ensure the following:

- ☐ That no unilateral decision on the benefits to be included in the fund are to be made.
- ☐ That not negotiations are made with any member representative who have not been duly elected or correctly appointed in the case of trade union representation.
- ☐ That the benefits included in fund are fair and equitable with funds for employees in a similar organisation within a common industry.

The implications for the member and employer representatives cannot be overlooked. Once the fund is in place, the board of trustees of the fund will be seen in its capacity as the representative employer within the retirement fund.

Any unfair labour practices involving fund benefits will, therefore, cite the board of trustees as the employer. Practices that could constitute unfair labour practices and, therefore, need to be addressed while the negotiations for the formation of the fund are underway, include not only the benefit structure of the fund, but also the definition of an actuarial reserve and the determination of an investment strategy.

II) Dispute Resolution Procedures

The Commission for Conciliation, Mediation and Arbitration (CCMA)

According to the Labour Relations Act, any employee has the right to refer any dispute or unfair labour practice to the CCMA. An unfair labour practice in terms of the Labour Relations Act includes the unfair conduct of the employer relating to the provision of benefits to an employee.

Bargaining Councils

Bargaining councils can be established by one or more trade unions and/or one or more employer organisations, provided they represent at least half of the employees (in the case of trade unions), or at least half of the employers in the particular sector of industry in which they operate or in the particular area in which they are based.

Once a bargaining council has been registered, they are granted wide powers including the power to establish and administer pension funds, provident funds and medical aid schemes for the benefit of one or more of the parties to the bargaining council or their members.

Bargaining councils also have the right to apply to the Minister of Labour for the extension of a collective agreement to persons who are not a party thereto i.e. non-trade union member employees or employers who do not belong to the employer organisation.

This could have major implications for existing funds where the bargaining council has set up a retirement fund and now submits a request to the minister for the extension of a collective agreement to include members of these existing funds.

1.2.6 The Divorce Act, 1979 (Act 70 Of 1979)

Pension assets are regarded by the government as special assets worthy of enhanced protection. Pension benefits are not reducible, transferable or executable except in the limited instances outlined in the Pension Funds Actand certain other Acts. One of the exceptions to the general rule is repayment of pension benefit to a former non-member spouse in terms of the divorce order issued by the High Court.

The Divorce Amendment Act, 1989 (Act No. 7 of 1989) and The Pension Funds Amendment Act that came into operation on 13 September 2007 created a radical shift with regard to the payment of divorce benefits. There have also been amendments to the Income Tax Act to clarify how the benefit is taxed in the hands of the non-member spouse.

The Impact of the Divorce Act on the payment of pension fund benefits will be considered in more detail in the relevant topic.

1.3 PENSION FUND CIRCULARS

From time to time, the Commissioner of the Financial Sector Conduct Authority deems it necessary to issue circulars to the retirement fund industry on matters that are of concern to him. Circulars sent to the retirement fund industry by the Commissioner are preceded by the prefix PF and are commonly known as the PF Circulars. PF circulars are not legislation, but directives from the Commissioner of the Financial Sector Conduct Authority.

While the Commissioner has issued a large number of circulars over the years, not all of these are still applicable. Many of the older circulars have also been replaced by subsequent legislative amendments to the Pension Fund Act and, in some instances, the Income Tax Act.

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There are also a few circulars that are of only passing interest, as they deal mainly with administrative communications between the Financial Sector Conduct Authority and retirement funds.

1.4 RETIREMENT REFORM

One should note that the whole future of retirement fund provision in South Africa has been under constant review for many years. A number of previous attempts to reform the system have foundered.

Overall, the government is engaged in a process to ensure that all South Africans have a reasonable amount on which to retire. Bear in mind that only just under ten million of the population are formally employed and have the opportunity of access to the formal type of retirement funding described in this module.

Here is a very brief summary of the proposals, as last published in 2012. Retirement funding will consist of four elements:

- ☐ **Tier 1:** The existing State Old Age Pension Grant (SOAG) will be paid to everyone.
- ☐ **Tier 2:** A new National Social Security Fund (NSSF) to which everyone will belong, irrespective of whether they are formally employed, unemployed or self-employed. Contributions will be collected on earnings up to the tax threshold, currently R59 750 per annum.
- ☐ **Tier 3:** Everyone in formal employment will have to belong to either a restructured private plan or a government run equivalent. Contributions will have to be made for earnings above the tax threshold up to R750 000 per annum.
- ☐ **Tier 4:** Each individual will be able to save any remaining discretionary income, but there will be no tax relief on contributions. Self-employed persons will, however, be able to contribute to a retirement annuity up to the R750 000 per annum limit.

These proposals were put together by an Inter-departmental Task Team committee (IDDT), consisting of National Treasury and the department of Social Welfare, and debated by Cabinet on many occasions. No agreement could, however, be reached, possibly due to the costs involved. However, many reforms to the existing system (TIERS 3 and 4) were identified as in urgent need of attention. So, while discussions on the overall plan have continued, National Treasury issued a number of discussion documents in 2012 and 2013.

1.4.1 National Treasury Papers

In May 2012, National Treasury published a document entitled Strengthening Retirement Savings, following the announcements made in the 2012 Budget Speech by the Minister of Finance. The paper provided the background and rationale of why certain reforms to the South African retirement system were necessary and set the scene for the five papers to follow, each of which was intended to deal with each aspect of the reform in some detail.

The five papers were as follows:

- ☐ ***Paper A: Charges in South African Retirement Funds.*** This paper reviewed the costs and charges within retirement funds and proposed measures intended to reduce them.
- ☐ ***Paper B: Enabling a Better Income in Retirement***. This paper reviewed the annuity markets and suggested measures to ensure that cost-effective, standardised and easily accessible products are available to the public.
- ☐ ***Paper C: Preservation, Portability and Governance***. This paper considered phasing in preservation on job changes and divorce settlement orders, and harmonising annuitisation requirements. The aim is to strengthen retirement provisioning, long-term savings and fund governance.

- ☐ ***Paper D. Incentivising non-retirement savings:*** This paper discussed how short- to medium-term savings could be enhanced, and dependency on excessive credit reduced, through tax-preferred individual savings and investment accounts. It also discusses the design of incentives to encourage savings in lower-income households.
- ☐ ***Paper E: Improving Tax Incentives for Retirement Savings:*** This paper proposed harmonising tax treatment for contributions to retirement funds to simplify the tax regime around retirement fund contributions.

Certain elements of the discussion papers have been passed onto law. In March 2016, the changes affecting the overall level of tax-deductible contributions to pension, provident and retirement annuity funds became effective.

The latest Taxation Laws Amendment Bill, which includes changes to the laws that govern provident and provident preservation funds, came into effect on 1 March 2021. This piece of legislation is the final step in National Treasury's process of harmonising the rules of retirement funds, including pension, provident, preservation and retirement annuity funds.

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Topic 2 Arrangement Of A Retirement Fund

LEARNING OUTCOMES

After studying the topic, the learner should be able to-

- Describe the functions of the key role players in a retirement fund.
- Understand the function of the Pension Fund Adjudicator and the Liquidator.

2.1 INTRODUCTION

Most people in South Africa contribute to retirement funds through an employer-sponsored scheme. Under this arrangement, the employer gives its employees the facility to contribute to a retirement fund that is run or overseen by the employer.

The employees are known as members and the employers are known as sponsors.

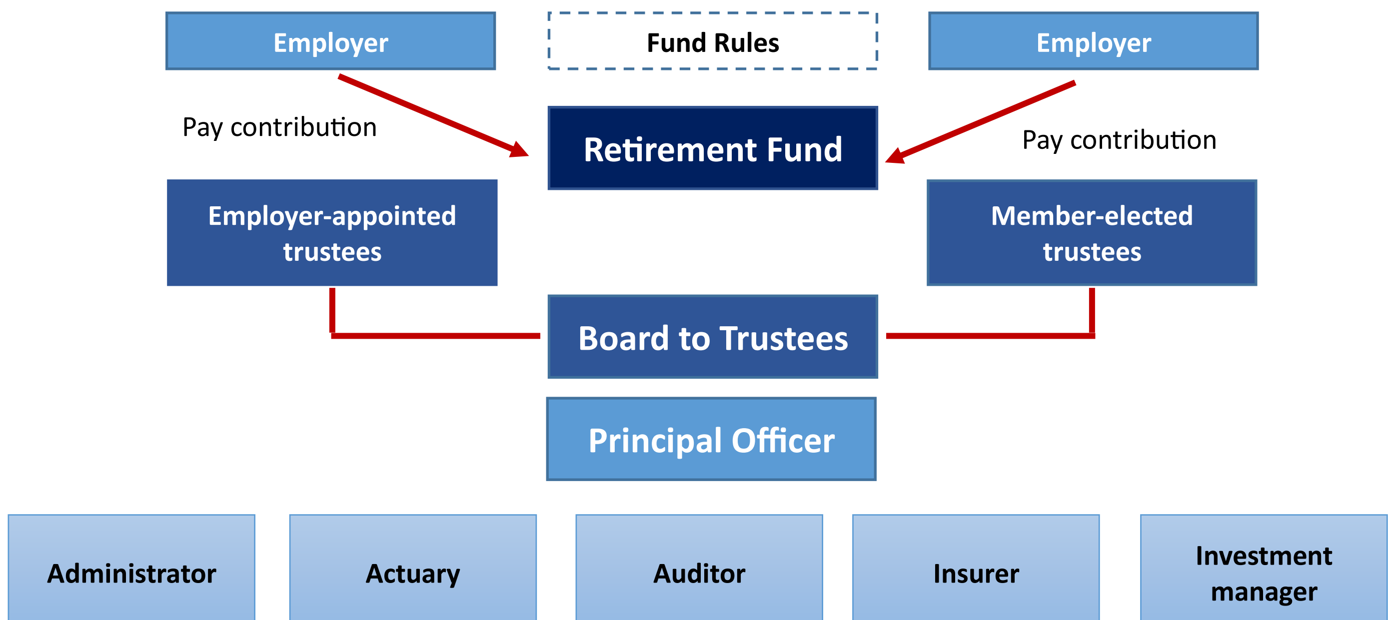
The main purpose of a retirement fund is to provide a retirement benefit to participating members on retirement, or to their dependants on the death of the member. In South Africa, it is common for retirement funds to also provide non-retirement benefits such as death and disability benefits. The trend is to allow members some flexibility to structure the benefits to suit their own needs.

Good governance of a retirement fund is of vital importance because funds hold member's money in trust for retirement. Usually, an employee's retirement fund investment is his only means of providing a financially secure retirement. If a fund is not well governed, it could compromise or even destroy all an employee's retirement savings.

A retirement fund is a complex arrangement and involves a number of role- players.

The diagram following shows the various role-players that could be involved in a retirement fund.

Figure 2.1: Role-players in a retirement fund



2.2 KEY ROLE-PLAYERS IN A RETIREMENT FUND

2.2.1 Employer (sponsor)

At the outset of a fund, the employer is usually involved in setting it up and choosing the benefit structure. This process may entail employee involvement, or, in the case of a negotiated fund, a union may be involved. The employer needs to make key decisions regarding the fund. These decisions include the following:

- Whether or not to have a retirement fund.
- What type of fund it should be, pension or provident? (This choice will become increasingly redundant as the right to a full cash lump sum at retirement form a provident fund gradually diminishes.)
- Whether it should be a stand-alone fund or part of an umbrella fund.
- How to communicate such decisions with staff?
- What process to follow in appointing/electing a board of trustees in the case of a stand-alone fund.

The above decisions are usually made in consultation with a benefits consultant and negotiated with employees.

Once a fund is in place, the employer has certain administrative duties and the duty to deduct and pay over contributions to the fund administrators, together with a detailed member schedule within a certain timeframe each month.

Directors of participating employers may be personally liable for payment of contributions to the fund.

2.2.2 Employee (Member)

In the negotiations between the employer and the employees, the question will come up as to who would qualify for membership of the fund. It is quite normal to find that the negotiations will result in minimum and maximum ages at entry into the fund being set.

The negotiators must remember that current employees must be given a choice as to whether they wish to join the new fund or not and be allowed to decide after 12 months. All future employees will, however, as a condition of employment, have to join the fund if they are eligible in terms of the criteria set.

2.2.3 Board Of Trustees

Once a fund has been implemented, a board of trustees is required. Section 7A (1) of the Pension Funds Act requires that every fund has a board of management consisting of at least four board members, at least 50% of whom the members of the fund shall have the right to elect. The other 50% of the board is appointed by the employer and often includes representatives from the human resources or finance departments who deal with fund-related matters. For very small funds, the minimum requirement of four trustees may be exempted on application if this is not possible or practical.

A trustee must attain prescribed levels of skills and training within 6 months of appointment.

In an umbrella fund, the right of member representation falls away on practical grounds. Section 7B (1) (b) allows the Commissioner of the Financial Sector Conduct Authority to exempt umbrella funds from this requirement.

Increasingly, professional independent trustees are being appointed to boards, mainly by the employer but in some cases, they are elected by the membership. There are definite advantages to having expert knowledge available during board meetings, as many of these professionals are retired actuaries, fund administrators and others who have worked in the employee benefits industry for many years.

Before professional independents can be used, the fund rules need to be inspected in case there is any impediment, such as a requirement that only active members and pensioners may sit on the fund's Board. The downside of using professional independents is that they will usually charge a fee for their services, but the costs will often turn out to be money well spent.

I) Governance Of Retirement Funds

Retirement fund assets are administered for the purpose of providing members with the retirement benefits promised in the rules of the fund. Thus, retirement funds hold fund assets for the benefit of members of the fund and should act in compliance with common and statutory law and the rules, codes and policies of the fund. This includes that they must act with integrity and good faith and in the best interests of members. The Financial Services Board's circular PF No. 130 entitled "Good governance of retirement funds" encapsulates best retirement fund governance practices in 13 principles.

Table 2.1: Principles of good governance of retirement funds

Principle	Detail
Principles 1 – 4: Governance structure	
1	The board of trustees is responsible and accountable to the members of the fund for its administration and prudent investment of the fund's assets. Trustees owe a primary duty of care to the fund and the members, and should work together, trust one another and be worthy of trust in return. The chairperson of the board should proactively lead the board impartially and without bias. The principal officer's duty is to the fund, and this overrides any responsibilities or obligations arising from being employed or remunerated by the employer (if applicable). The principal officer fulfils the function of administrative officer of the fund and is responsible for its regulatory compliance. The roles of chairperson and principal officer should be kept separate. The board of trustees and principal officer must avoid conflicts of interest. In addition to its rules, a fund should have a code of conduct, an investment policy statement, a communication policy and a performance assessment tool for trustees.
2	Board members should have sufficient capacity to deal diligently and thoroughly with their duties and responsibilities. The board may establish subcommittees to assist it with specific oversight or other board responsibilities. Each subcommittee must have a written mandate setting out its functions, scope, authority, membership requirements, etc.
3	Board members should receive induction as well as ongoing training on risk management, investment strategies, benefit structures, the legislative and regulatory framework, taxation and legal matters, and actuarial and industry reform issues.
4	The board, its subcommittees and the principal officer should be subject to performance appraisals at least annually. The board should act against trustees who breach the fund's code of conduct or contravene any trustee responsibilities imposed upon them. Such action could call for vacation of or suspension from office.

Principle	Detail
Principle 5 to 8: Governance of fund operations	
5	An appropriate system of internal controls should be in place to ensure that operational and oversight responsibilities are carried out in accordance with the rules of the fund and in compliance with the law. Such controls should be subject to regular, effective and comprehensive board review.
6	Where it lacks sufficient expertise to make fully informed decisions and fulfil its responsibilities, the board should seek expert advice. The board should apply its mind to any advice given, and if uncomfortable with the advice received, request a second opinion.
7	The fund should have a policy that provides a set of guidelines to enable it to identify, assess, manage, monitor, control and report its risks. The board should review such policy at least annually.
8	Since investment performance is the most important factor in determining whether the fund will deliver on promised retirement benefits, the board should- • Ensure the mandates given to service providers clearly require compliance with Regulation 28 on fund and member level and define the board's expectations and reporting requirements regarding investment performance. • Review the fund's investment policy statement at least annually to ensure it remains appropriate in terms of the member profile and needs of the fund. • Appoint an independent custodian of the investment assets to give it direct access to custodian information about fund investments.
Principles 9 to 13: Management of stakeholder relationships (where stakeholders are members, employers/sponsors and Commissioner of the Financial Sector Conduct Authority)	
9	Trustees should have access to all information relating to the fund to enable them to make informed decisions. All information about the fund is confidential and may not be released to any person unless such person has a lawful right to such information, such as the rights of members to obtain copies of registered rules, actuarial valuations and audited financial statements. A communication policy should be established to govern the disclosure of fund information to members.
10	The board must communicate aspects of the operation of the fund, including the performance of the fund investments, which are of relevance to members and will assist them to assess the credibility and trustworthiness of administration of the fund and the delivery of benefits. Where a fund offers members investment choice, the details of the investments in respect of which members may make an election must be described, setting out the severity of any associated risk and the performance benchmarks, as well as the underlying type of investments. Members should be able to make informed decisions from such information.
11	The board should establish a channel of communication with the employer/sponsor, which should be through the chairperson of the board.
12	The board should establish a policy to manage the selection and appointment of and reporting by services providers. Such policy should deal with conflicts of interest in the provision of services by service providers.

Principle	Detail
13	The board should ensure that the requirements of any regulatory authority, particularly those of the Commissioner of the Financial Sector Conduct Authority are complied with. Any query or correspondence from such regulatory authority should be dealt with expeditiously and thoroughly.

2.2.4 Chairperson

The chairperson of a fund is appointed in terms of the fund's rules. The chairperson runs the trustee meetings and must give everyone an opportunity to participate and vote on decisions, where applicable. It is preferable that the chairperson be appointed by or elected from the board of trustees. However, the chairperson need not be a member of the board but will have no voting right if he is not a board member.

Sometimes the chairperson has a casting vote in addition to a deliberative vote, which will be used to break deadlocks when for and against votes are equal.

2.2.5 Principal Officer

The members of the board of trustees are a combination of managers from within the company, appointed by the employer, and employees who have been elected by the members of the fund. All of them will have their normal duties and functions, which will have to be performed, and will thus only be able to act as board members when they are required to attend meetings or monitor reports.

The Pension Funds Act (in Section 8) recognises this and, therefore, states that every fund must appoint a principal officer. The Commissioner may object to the appointment of a person in this role and has been granted extensive powers to assess the principal officer as fit and proper to perform his duties

The principal officer is the responsible official accountable to the Commissioner and would be the person to represent the fund if it were to sue or be sued. The principal officer must be appointed within 30 days of the registration of the fund and, should he resign, a new principal officer must be appointed within 30 days.

The principal officer whose services are being terminated has a statutory duty in terms of Section 8 (6) (a) to furnish the Commissioner with a written report within 21 days, outlining the reasons why his term of office is being terminated.

Most importantly, the principal officer is required to act as a whistle-blower, if that person feels that some aspect of the operation of the affairs of the fund might prejudice the fund or its members, by reporting the matter in writing to the Commissioner.

The duties of the principal officer, as required by the Act and further explained in PF130, are as follows:

- ☐ Ensure that decisions of the Pension Fund Board of Trustees are executed.
- ☐ Ensure that the pension fund complies with the formal requirement of the law, including directives from the Commissioner, SARS and any other relevant regulatory authority.
- ☐ Liaise, on behalf of the board, with service providers to the pension fund.
- ☐ Contribute to the board meetings even though the principal officer does not have a vote.

2.2.6 Service Providers

A pension fund is governed by a board of trustees who generally do not have the expertise to perform all the necessary administrative functions of a fund. Therefore, the board of trustees may elect to contract with other service providers to perform such functions, although the board remains ultimately responsible.

These services may include the following:

- ☐ Fund administration
- ☐ Benefit consulting services
- ☐ Investment management
- ☐ Actuarial services
- ☐ Risk-benefit consultation
- ☐ Annual fund audit.

Insured funds may have all of the above functions included in the departments of the insurer's office apart from the auditing function, where there is a statutory duty to use an external professional.

These service providers are considered in the subsections following.

I) Administrator

The fund will also appoint an administrator. In the case of a privately administered fund, this is the area or persons authorised and appointed to process all the operational responsibilities of a retirement fund. In the case of other administrative arrangements, the appointed entity by way of a service level agreement processes all the operational responsibilities of a retirement fund.

II) Fund Valuator (Actuary)

Benefits in a retirement fund are there for the members when they retire. The contributions collected from the employer and members will, therefore, be within the fund for a long time and safeguards need to be in place to ensure that the money is still there, when needed, to pay the retirement benefits.

Changing circumstances, such as higher than anticipated salary increases, or lower than expected investment returns could, however, deplete the value of the fund without anyone even being aware of the danger to the retirement benefits of the members.

For these reasons, it is a legal requirement that every retirement fund appoint a suitably qualified valuator to do a valuation of the fund's assets and compare these to the fund's liabilities at least once every three years.

This triennial valuation is a requirement in terms of Section 16 of the Pension Funds Act. A suitably qualified person is a person who is an actuary or a person with similar abilities and qualifications to an actuary. Any person who has been accepted by the Commissioner of the Financial Sector Conduct Authority as a valuator can conduct the valuation.

Note that, where an exemption from the conditions of Section 9A of the Pension Funds Act is granted, the fund will not need to retain the services of a valuator.

The role of the actuary includes the following:

- ☐ Ensure that the fund has been administered in accordance with the rules of the fund and current legislation.
- ☐ Determine whether the correct investment return has been allocated to each member's share and that the assets and liabilities of the fund match.

- ☐ Ensure that the correct benefits have been allocated to exiting members.
- ☐ Ensure the correct allocation of assets between member accounts and surpluses provided for in the rules of the fund.
- ☐ Ensure that pensioner benefits (if any), are administered within the legislative requirements.

III) Auditor

Every retirement fund must appoint an external auditor who is registered in terms of the Auditing Profession Act, 2005 (Act No. 26 of 2005). This appointment is required by Section 9 of the Pension Funds Act.

The auditor is responsible for checking the books of the retirement fund to make sure that no money is missing from the fund. Once the auditor is satisfied that all the monetary affairs of the retirement fund are in order, he must certify the revenue statement and Statement of Financial Position and send them to the Commissioner of the Financial Sector Conduct Authority. The auditor prepares the financial statements of the retirement fund, but this does not absolve him of the responsibility to certify the truthfulness of the contents.

IV) Benefits Consultant

Once an employer has decided that a pension fund should be set up for the staff of the organisation, and the employees have been approached and agreed to the principle, a professional benefits consultant should be approached.

The benefits consultant will be able to assist the employer and employees in deciding which benefits will be best suited for the prospective members of the fund.

Benefit consultants know the costs linked to the different options and benefits that may be required and will, therefore, be in a position to advise the negotiators about the viability of their ideas.

On reaching consensus about the benefits and type of fund to be created, the benefit consultant may recommend the appropriate person to draft the rules of the fund.

The benefits consultant will be up to date with modern trends in the retirement funds industry and will be able to keep the trustees updated.

V) Insurer

If the fund insures any benefits, a policy contract is entered into between the insurer and the fund.

VI) Investment Manager

In view of the fact that the value of any future retirement benefits payable to members depend very heavily on the investment results of the overall retirement fund, the appointment of a good investment manager is crucial.

The management board must, therefore, appoint a competent person or organisation to manage the investments to be made with the money contributed to and accumulated in the retirement fund. In appointing an investment manager, the management board cannot, however, relinquish its responsibility for investing the money in a satisfactory manner. The investment strategy decisions will always rest with the management board.

As indicated earlier, in choosing an investment manager, the board could consider the following:

- ☐ A life insurer or various different long-term insurers.
- ☐ Unit trust/collective investment scheme managers.
- ☐ Merchant banks.

- ☐ Stock brokers.
- ☐ Professional investment managers who have set up their own infrastructure, specifically to provide this type of service.

The board of trustees of a fund administered by an insurer will, more than likely, leave the investment of the contributions and accumulated monies in the competent hands of the insurer concerned. Life insurers are, in fact, the only bodies that can provide insurance policies, which contain certain investment guarantees. The management board must remember that the investment strategy of the particular fund and, therefore, the returns obtained, remains its responsibility.

2.3 THE PENSION FUND ADJUDICATOR

It sometimes happens that there is a disagreement between a member and the fund. In the past, the only recourse that a member had was to go to a court of law and to try and get a favourable decision at considerable expense.

The government, being aware of this problem, created the position of the Pension Funds Adjudicator. The Minister of Finance has, in consultation with the Policy Board, appointed a Pension Funds Adjudicator to address any complaints that may arise as a result of the actions of a fund, its board of trustees or its administrator. The adjudicator is a person nominated by the Minister of Finance in consultation with the Policy Board at the Financial Sector Conduct Authority. The Pension Funds Adjudicator is available to settle disputes with effect from 1 January 1998.

The following persons can lodge a written complaint with the fund or an employer who participates in the fund.

- ☐ A member or former member of the fund.
- ☐ A beneficiary or former beneficiary of the fund.
- ☐ An employer who participates in the fund.
- ☐ A board or a board member.
- ☐ Any person who can show an interest in the complaint.

The complainant is entitled to expect a written reply within 30 days of the complaint having been submitted. Should the complainant not receive a reply, or be unhappy with the reply, the complainant may lodge the complaint with the Pension Funds Adjudicator.

The main objective of the office of the Adjudicator is to dispose of any complaint received in a procedurally fair, economical and expeditious manner. In order to achieve this, the adjudicator may before investigating the claim, insist that the complainant first approach any organisation established for the purpose of resolving disputes in the pension fund industry that have been approved by the Commissioner or investigate the complaint and may make a decision that will have the same standing as an order of a court of law.

Should the complaint have been referred to an established organisation in the pension fund industry and the complainant not be satisfied with the result, the complainant still has the right to refer the complaint back to the Adjudicator.

There is a three-year prescription period, but the Adjudicator may waive the time barring in terms of the provisions to the Prescription Act, 1969 (Act No. 68 of 1969) relating to debt. Exercising this right is very rare and will only apply in exceptional circumstances where the complainant is able to demonstrate that he could not reasonably have expected or known that a course of action was open to him.

2.4 THE LIQUIDATOR

While most people tend to accept the fact that a business could merge with another company, be bought out by a competitor, or even close as a result of going insolvent, they tend to forget that the retirement fund for the employees of the business will also be affected. The retirement fund will probably also have to merge, accept a takeover, or be dissolved.

Where the retirement funds linked to the two employers are to merge, or where the one is to be absorbed by the larger fund, a valuator will need to certify the soundness of the merged fund.

The valuator also ensures that existing benefits applicable to the members of either of the funds will not be adversely affected by the merger. Should there be a substantial change to any of the benefits applicable to one of the funds; member approval will need to be obtained before the merger can go ahead.

Should a retirement fund need to be dissolved, the Pension Funds Act makes provision for this eventuality by stipulating that a liquidator must be appointed. The liquidator, who is usually an accountant or valuator not directly connected to the dissolving retirement fund, must apply for appointment with the Commissioner of the Financial Sector Conduct Authority.

Once the liquidator's appointment has been approved by the Commissioner of the Financial Sector Conduct Authority, he will act as the person managing the business of the fund. The first duty of the liquidator will be to draw up a preliminary account and Statement of Financial Position and then suggest a scheme for the liquidation and distribution of the remaining assets, if any.

To ensure the protection of any pensioners who are currently members of the fund, which is now to be liquidated, one of the first and most important liabilities the liquidator needs to address is the provision of continued retirement benefits for such pensioners. This is usually accomplished by purchasing an annuity for the pensioner with an insurer who will accept the responsibility of the payment of the pension to the pensioner.

Topic 3 Investment Strategy Of A Retirement Fund

LEARNING OUTCOMES

After studying the topic, the learner should be able to-

- Outline the factors to be considered when evaluation the investment strategy of a retirement fund.

3.1 INTRODUCTION

The discussion below about the investment strategy of retirement funds is for the most part not applicable to pension and provident funds that provide individual investment choice to members, because members of these funds themselves select the investment composition of the policies or collective investments that one day will provide the benefits. They make their selection from a so-called basket of policies or collective investments (as the case may be) made available by the trustees.

The investment strategy of a particular pension fund, provident fund (and possibly a small number of preservation funds) that do not operate in the manner is driven by various factors of which the most critical are as follows:

- The nature and term of its liabilities.
- Whether the fund is growing or contracting.
- The fund's solvency position.
- Statutory restrictions on investments.
- The risk return attitude of its members or, as a proxy of its members, of its trustees.
- Asset-liability modelling.

These factors will be considered in the subsections following.

3.2 NATURE AND TERM OF THE LIABILITIES

Retirement funds invest in assets to meet liabilities that arise from the benefits to be provided at some time in the future. To minimise the risk of failing to meet the liabilities when due, it is always recommended that the assets held behave in a similar manner to the liabilities.

Firstly, the term of the liabilities needs to be considered. For example, if the fund has liabilities that are due in the very near future, it is advisable to hold cash to fund the amount needed to settle them. At the other extreme, if the liabilities are only due in 40 years, it is advisable to hold equities, as they are generally the best-performing asset class over a very long-time horizon.

The nature of the liabilities also needs to be considered. By nature, it is meant whether the liability is a fixed known amount (nominal) or an unknown amount increasing in line with some factor such as salary inflation (real). For example, a flat rate pension is a nominal liability, as we know the amount of each payment in advance and the exact monetary amounts are known at the outset. A pension that increases in line with an inflation index is a real liability, as future payments are unknown and are expected to increase in line with inflation in the future. For nominal liabilities, it is common to use assets such as fixed-income government or corporate bonds that provide fixed monetary amounts at fixed future dates. In effect, if the future payments are known in advance, the fund can match the payments from the assets to the future payments out of the scheme. For real liabilities, it is common to use assets that are expected to provide income streams that appreciate in line with (or above) inflation. Assets that provide these types of income stream are shares (some companies' earnings and dividends tend to increase at a higher rate than inflation) and bonds with coupons that are increased in line with a published inflation index (known as inflation-linked or index-linked bonds).

In a defined contribution environment, the assets and liabilities are always matched because the member receives the assets, no more and no less. The trustees must still consider the purpose of these assets when deciding on investment portfolios, even though there is no risk of insolvency to the retirement fund. The reason that these assets are placed with the retirement fund is to provide benefits in the future. The first goal of the investment strategy in this case is to provide returns at least equal to or in excess of inflation. This would suggest that most defined contribution funds should invest heavily in real assets, such as equities.

One of the complications with defined contribution funds arises when a member is near retirement. The member will need to be protected from drastic changes in market values that are characteristic of equity investments and against expensive pension purchase terms on retirement. Investing in nominal assets such as government bonds can dilute both of these risks. The fact that different members in the same defined contribution fund require different investment strategies has prompted many defined contribution funds to offer different types of investment portfolio from which their members may choose. Many of the funds also advise their members on what types of fund are considered suitable for their specific needs or risk profile.

3.3 GROWING VERSUS CONTRACTING FUND

A fund that is growing receives more contributions and investment income than it pays in benefits. Unless the fund rules provide otherwise, the fund can thus use some of this to pay benefits and invest only the difference. Using this method, it will not need to sell investments until the benefits start to exceed the contributions plus investment income. There are various advantages to being in this position. Firstly, there is no need for liquidity on the investments that are made with the contributions in excess of the benefits paid. This allows the retirement fund to invest in a wider range of assets and also in assets that carry higher expected returns in compensation for the lower liquidity. It also allows the fund to invest in many structured investment products that provide attractive payoff profiles to investors who hold the products to maturity. Secondly, as the near-term liabilities are paid from contributions, the investments are made to meet long-term liabilities. This allows the retirement fund to invest in assets with volatile market values, as the positive cash flow makes it unlikely that there will be forced sales that will require the liquidation of assets at unfavourable times.

A fund that is contracting needs to sell assets to meet benefit payments. Funds in this position could aim to hold assets with high-income yields, which allow them to sell fewer assets because a larger part of the benefit payments are met from the income produced by the assets. Such funds could also aim to invest in assets with stable market values as they expect to sell in the near future. A drop in market values might force them to sell more assets than planned, which could threaten their solvency position. The assets most suitable for contracting funds could be government bonds and cash.

3.4 SOLVENCY POSITION

The solvency of a fund is measured by the difference between its assets and liabilities. In South Africa, a retirement fund needs to have assets equal to or in excess of its liabilities. A fund that has a very strong solvency position is not at risk of insolvency due to changes in market values and can thus invest in volatile assets such as shares. A fund that is only just solvent cannot risk having its asset value reduced. It will therefore avoid being too heavily invested in volatile assets and should invest in more conservative assets such as bonds and cash.

3.5 STATUTORY RESTRICTIONS

A retirement fund investment strategy is legislated by the prudential investment guidelines contained in regulation 28 of the Pension Funds Act. Thus, the share exposure of any retirement fund cannot exceed 75%, even though the fund's liability profile and solvency position would make a higher exposure optimal.

3.6 ATTITUDE TO RISK

As the trustees are ultimately responsible for determining investment strategy, their attitude towards risk will affect the fund's investment strategy. For example, if the trustees are quite risk averse, they will generally discourage the investment managers from investing heavily in equities.

Similarly, in defined contribution schemes the members might have choices in respect of the investments, and the overall asset mix of the fund will be greatly affected by the members' aggregate investment risk profile.

3.7 ASSET-LIABILITY MODELLING

Asset-liability modelling (ALM) is one of the tools for setting investment strategy. ALM is based on the idea that investment returns are unpredictable from year to year, but that they have a certain probability distribution (e.g. a normal distribution). Combining the assumption of some statistical property for investment returns with modern computing power, it is relatively simple to project the financial position of the fund into the future under thousands of different scenarios of investment returns.

As an example, ALM could be used to project the solvency position of a retirement fund under an aggressive investment strategy, and trustees can take, say, the worst 10 outcomes in the sample to assess whether they are comfortable with the potential downside from that particular strategy. ALM is rapidly becoming one of the cornerstones of funds' investment strategies.

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Topic 4 Concepts Relating To Retirement Funds

LEARNING OUTCOMES

After studying the topic, the learner should be able to-

- Understand the fundamental concept relating to retirement funds.

4.1 APPROVED ARRANGEMENTS

In its most basic form, a pension fund benefit arrangement can only be provided as an approved arrangement.

The term approved refers to any entity that has been approved by South African Revenue Service (SARS) as meeting the requirements of one of the following definitions:

- ☐ A benefit fund, which includes a friendly society registered in terms of the Friendly Societies Act or any fund established before 13 June 1986; which is not so registered solely because of the provisions of the Friendly Societies Act.
- ☐ A pension fund, provident fund, retirement annuity fund, pension preservation fund or provident preservation fund that has been registered in terms of the Pension Funds Act.

4.2 MEMBERSHIP REQUIREMENT

In terms of the definitions of pension fund and provident fund in Section 1 of the Income Tax Act, when providing an employee with a pension or provident fund, the Income Tax Act requires that an employee/employer relationship exist between the business entity and its employees.

Partners in a partnership are also regarded as employees in terms of pension fund and provident fund. This means that partners who were not previously employees of the partnership will now also be eligible for membership to the pension fund.

A pension or provident fund may thus be established by the following entities:

- ☐ Company for the benefit of its working, salaried directors and other salaried employees.
- ☐ Close Corporate for the benefit of its working, salaried members and other salaried employees.
- ☐ Sole proprietor for the benefit of his salaried employees.
- ☐ Partnership for the benefit of salaried employees and partners.

Once the employee qualifies to be a member of a pension or provident fund, membership becomes one of the conditions of employment for all new employees. If this is not the case, the Commissioner of Inland Revenue will not approve the fund.

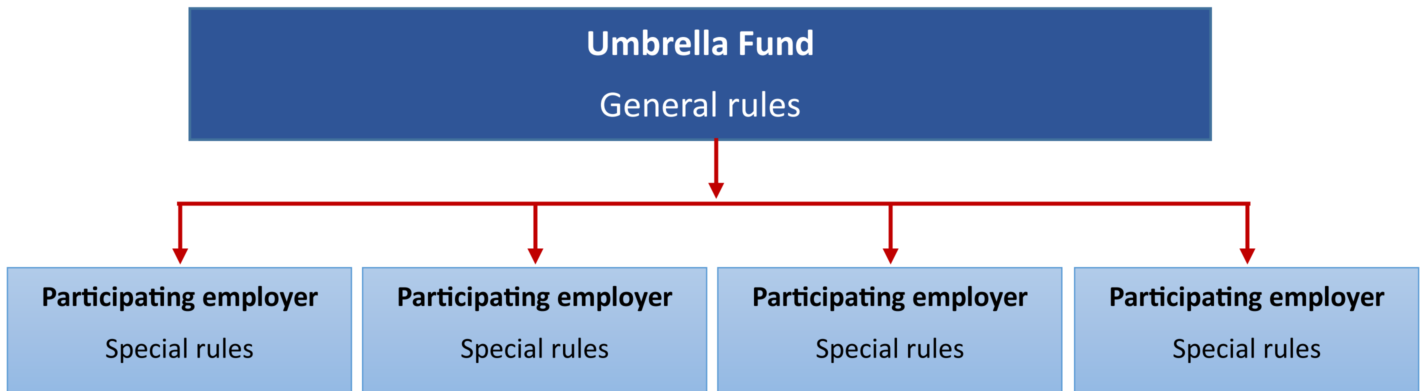
However, eligible persons who were in the employer's employ before the employer's participation in the fund, have a period of twelve months from the date of establishment or the date that they qualify, to decide whether they wish to become members of the fund or not.

Membership of more than one fund is permissible, provided that the employee qualifies in terms of the eligibility rules/conditions of both funds.

4.3 UMBRELLA FUND

An umbrella fund is an arrangement where an overall fund is set up with the main structures outlined in a set of general rules. Participating employers' fund arrangements are then registered under the umbrella fund, each with their own particular benefit structure outlined in a set of special rules. The participating employer fund does not require its own board of trustees.

Figure 4.1: Structure of an umbrella fund



Umbrella funds are a cost-effective option for smaller employers. They have also become attractive to larger entities who wish to dispense with the obligations and duties of a board of trustees associated with a stand-alone fund.

However, the funds that make use of the administration alternative will be limited to a degree in terms of investment options and benefit structures compared to privately administered funds. Note that, in an umbrella fund arrangement, the participating employers have no relationship to each other.

4.4 ACCRUAL RATE

An accrual rate is a very important part of determining the benefit in terms of a retirement fund. The accrual rate is the rate at which the member built up pension benefits whilst being an active member of a defined benefit scheme.

It is most commonly expressed as a fraction, such as $^{1}/_{30}$ or $^{1}/_{60}$ or $^{1}/_{80}$. The lower the denominator, the better the pension benefit the member will receive for an equivalent amount of pensionable service.

An accrual rate can sometimes be expressed as a percentage e.g., 1.25% (1/80th). So, in a final salary scheme for example, the member may have accrued 1.25% of their final pensionable salary for each year of pensionable service.

4.5 ACTUARIAL VALUATION

An actuarial valuation is a type of appraisal of a pension fund's assets versus liabilities, using investment, economic and demographic assumptions for the model to determine the funded status of the retirement fund.

4.6 PENSIONABLE SERVICE

This item used to be needed to establish the tax-free portion of any gratuities paid at retirement (in accordance with the Second Schedule of the Income Tax Act) and is still used to work out the benefits on defined benefit schemes. While pensionable service is, more often than not, the same as the period of employment, this is not necessarily always the case. It is possible that there was a waiting period before a member became eligible to join the fund, or that past service could be purchased to enhance benefits.

4.7 NORMAL RETIREMENT AGE

It has historically commonly been pitched at age 65, although some occupations, such as airline pilots, are not generally allowed to fly a commercial aircraft beyond 55.

There is a general groundswell of opinion that, in the interests of the skills shortage and, more importantly, the fact that many people reach age 65 with insufficient retirement capital accumulated, and due to longevity, i.e. people living longer than expected, there should be no fixed retirement age preventing people from working until they wish to retire.

This is evidenced in a change in the definition of a retirement annuity that, until recently, required members of a retirement annuity fund to retire by no later than age 70 and take a pension. This did not encourage older people to carry on working as, apart from not being very tax efficient, deferring a pension to the actual date of retirement will generally result in a higher annuity, as well as extra funds to be used to buy the annuity.

This change has not been implemented for pension and provident funds.

Should there be different “normal retirement ages for various classes of members, this must also be stated in the rules.

4.8 MINIMUM INDIVIDUAL RESERVES

The minimum benefit is the member's minimum individual reserve. In the case of a defined-benefit fund, the minimum individual reserve is the full actuarial value, and in the case of a defined-contribution fund, it is the member's share of the fund.

4.9 MINIMUM PENSION INCRASES

The Pension Funds Act also prescribes minimum pension increases where pensions are being paid from a pension fund, in other words, the lesser of a full inflation adjustment and the increase that the fund can afford.

In addition, trustees must set and communicate a policy concerning a target pension increase and must aim to pay increases in line with or in excess of the amount implied by this policy.

The minimum pension increases must be reviewed at each statutory valuation date, which in the case of a defined-benefit pension fund is once every three years and probably once a year for a defined-contribution fund.

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4.10 DEFERRED RETIREMENT BENEFIT

The deferred retirement benefit allows retired members to continue their membership even though they have retired from their employer. This means that the member is no longer forced to retire from the fund when they still have other sources of income and do not need the retirement benefit yet.

4.11 EMPLOYER SURPLUS ACCOUNT

Surplus in relation to a defined-contribution fund means the assets in excess of the total sum of the individual shares of the members. This surplus could have arisen from one of the following:

- Members leaving the fund with a benefit less than their full share of the fund.
- Any additional or ad-hoc contributions made by the employer.

In relation to a defined-benefit fund surplus is the excess of assets over the actuarial liabilities of the fund, based on actuarial assumptions. Surplus could arise due to one of the following:

- Investment returns in excess of those anticipated by the actuary in setting the contribution rates.
- Over-contributions made by the employer.

4.12 RETIREMENT BENEFITS COUNSELLING

The default regulations issued in terms of the Pension Funds Act defines retirement benefits counselling as the disclosure and explanation, in a clear and understandable language, including risks, costs and charges of the available investment portfolios, the fund's annuity strategy and any other options made available to members.

Regulation 39 states that members must be given access to retirement benefit counselling not less than three months prior to their normal retirement age as determined in the rules of the fund (and as may be prescribed). It however offers little guidance as to what exactly this service must entail.

The Financial Sector Conduct Authority subsequently published a guidance note providing more clarity on (inter alia) the concept of retirement benefit counselling. PF Guidance Note No.8 of 2018 states that retirement benefit counselling may be provided either in person or in writing. In either event, the fund must retain a record thereof. The person providing counselling (as appointed by the fund) does not need to be a representative of a Financial Services Provider in terms of FAIS, but the board must be satisfied that the person who provides the retirement benefit counselling is suitably qualified and experienced and able to properly manage any conflicts of interest.

Retirement benefit counselling does not include advice, even on tax matters, and members should be expressly informed of this fact. If advice is also provided, then the person providing the advice must be a registered representative or tax practitioner.

It is recommended that retirement benefits counselling should be provided no longer than 6 months prior to a member's retirement from the fund and the board should make every effort to ensure that the information provided is still relevant and appropriate at retirement age.

When members are given access to retirement benefit counselling, a disclosure and explanation must be provided in clear and understandable language, including fees, risks, costs and charges of the available investment portfolios, the fund's annuity strategy and any other options made available to members.

4.13 DEPENDANT

A dependant is clearly defined in the Pension Funds Act. Dependant in relation to a member means one of the following:

- ☐ A person in respect of whom the member is legally liable for maintenance, for example, children from a current or past relationship, or where the member was paying maintenance towards an ex-spouse in terms of a divorce order.
- ☐ A person in respect of whom the member is not legally liable for maintenance, if such a person:
  - Was, in the opinion of the board of trustees, upon the death of the member dependent on the member for maintenance, for example, an elderly parent.
  - Is the spouse of the member, including a life partner or any spouse or civil union partner married under the Marriage Act, 1961, the recognition of Customary Unions Act, 1998, the Civil Union Act, 2006 or under the tenets of any religion.
  - Is a child of the member, including a posthumous child (child born after the death of the parent), an adopted child and an illegitimate child?
- ☐ A person in respect of whom the member would have been legally liable for maintenance, had the member not died, for example, a person to whom the member was engaged to be married.

Therefore, an ex-spouse is not a dependant, unless the member was paying maintenance to that spouse after the divorce had taken place, and if a member was in the process of getting divorced, that spouse is still considered to be a dependant.

Even major children of a deceased member automatically qualify as dependants and must, therefore, be considered for the payment of death benefits.

Topic 5 Product Specific Features And Benefits

LEARNING OUTCOMES

After studying the topic, the learner should be able to-

- Describe the features of pension and provident funds.
- Differentiate between contribution and defined benefit fund.
- Explain the requirements bestowed on retirement funds in terms of the default regulations.
- Differentiate between inclusive or exclusive costed funds.
- Understand the tax treatment of pension fund contributions and benefits.
- Apply the principle of aggregation.

5.1 INTRODUCTION

In this module, only group employer-sponsored retirement funds are considered. Employer sponsored retirement funds means that the employer contributes to the retirement fund.

In some funds both the employer and the member contribute (by way of a deduction from the member's salary). This is known as contributory funds. In non-contributory funds, only the employer contributes on behalf of members.

In South Africa, almost all funds are contributory, with both the members and the employer contributing to the fund.

Although retirement annuities are classified as retirement funds, and an employer may decide to deduct contributions from employees' salaries and pay them over to a provider, these are not true group arrangements.

Possibly the most important characteristic of a retirement fund is the way in which benefits are defined. There are two broad classes of fund structures: defined benefit funds (also known as benefit promise funds) and defined contribution funds (also known as money purchase funds).

The second major characteristic of a retirement fund is whether it is a pension or a provident fund. However, in light of the new amendments to simplify the taxation of retirement funds, the distinction between pension and provident funds are falling away.

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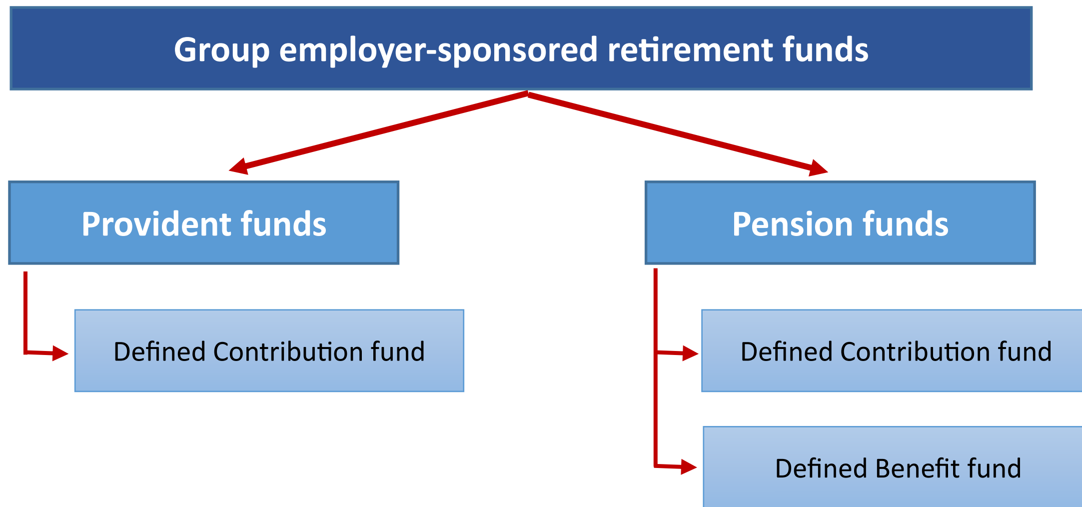
Figure 5.1: Different types of group employer sponsored retirement funds



5.2 PENSION FUNDS

Pension funds are designed to provide the retired member with a pension income during retirement, also known as an annuity. A maximum of one-third of the retirement benefit may be taken as a lump sum and a portion of such a lump sum may be tax-free. Compulsory annuitisation applies to fund balances above R247 500.

The balance of the retirement benefit needs to be used to purchase a compulsory income (annuity) to provide the member with a retirement income. Some funds, principally the larger self-administered funds, do not purchase annuities, but rather take on the task themselves. In both cases, the income from the annuity will be fully taxable.

We can differentiate between a defined contribution fund and a defined benefit fund.

Many retirement funds have switched in recent years from defined benefits to defined contributions for the following reasons:

- A defined contributions fund is easier for members to understand the benefits.
- With a defined contributions fund, members have a wider range of choices and greater flexibility.
- There is less complexity in terms of surplus distribution, with a defined contribution.
- The administration requirements are less onerous for a defined contributions fund.
- The financial risks to the sponsoring employer are considerably lower for a defined contribution scheme.

5.2.1 Defined Benefit Pension Funds

I) Benefits

In a defined benefit fund, the benefits that will be paid to the member at retirement are defined in advance.

Usually the retirement benefits are defined in terms of the following:

- The member's salary in the year (or an average over some number of years) prior to retirement.
- The length of time the retiring individuals was a member of the scheme.
- An accrual factor.

Most funds make provision for annual increases in the pensions provided to retired members to maintain the real value of the pension benefits. Since 7 December 2001 it is compulsory for boards of funds to aim to award an increase of a percentage of the consumer price index.

An example of a benefit formula is as below:

$$\text{Annual pension on retirement date} =$$
$$\text{the accrual factor } X \text{ the final or final average salary } X \text{ years of membership at age of retirement}$$

EXAMPLE

Company A provides a retirement benefit equal to the following:

Accrual factor X Final salary X years of service

The accrual factor = $\frac{1}{50}$

A member retiring with a salary of R10 000 per month for 20 years of service will receive the following pension:

$$\frac{1}{50} X\ R10\ 000\ X\ 20 = R4\ 000 \text{ per month}$$

II) Contributions

Defined benefit schemes provide for monies required to pay benefits in two broad ways: pay as you go or funded.

In a pay as you go regime, the current contributions are used to pay the benefits to members already retired. In effect, the currently employed members (known as active members) pay the retired members' benefits. This method is common in many state-sponsored schemes in EU countries. The downside of these schemes is that if the proportion of retired members to active members increases, active members carry an increasing financial burden. This has, in fact, been the case in the EU countries, where low birth rates since the 1960s have led to an increase in the ratio of retired to active members, forcing many countries to cut benefits in order to achieve fairness between generations.

In a funded scheme, the active members and the employer contribute monies into an investment fund that is held to provide for the future benefits of the current active members.

Thus, the main difference between a funded and a pay as you go scheme is that current contributions are used to provide benefits in the future rather than to pay current benefits to retired members. Funded schemes also provide members with the security that their accrued benefits are secured and are therefore not vulnerable to the employer's possible insolvency.

In South Africa, employer-sponsored retirement funds operate on a funded basis. The employees contribute fixed amounts (usually a percentage of salary) into the retirement fund and the employers then pay whatever the fund actuary deems necessary from time to time to make sure that future benefits can be met by the retirement fund. The value of assets (in the form of investments) that are needed today to provide future benefits is based on the fund's actuarial valuation, which basically determines the present value of the liabilities that have accrued for the retirement fund. One should note that the liabilities accrue in a fairly predictable manner, whereas the asset values can be volatile (especially if the fund holds shares as assets).

The employer must therefore be prepared to contribute more than expected if the asset values or growth is poor or if the liabilities increase dramatically (e.g. due to a higher than expected number of members becoming disabled). Conversely, if the investment returns are higher than expected, or if the number of claims (deaths or disabilities) is fewer than expected, the employer's required contributions can decrease significantly.

This uncertainty means that the employer carries the majority of the investment and other risks in a defined benefit scheme. The members must, however, realise that the employer may be forced to ask the board of trustees to cut future benefits or to close the fund or convert to a defined contribution basis, rather than increase contributions to allow the retirement fund (and the sponsor) to remain solvent. With that in mind, members should monitor the financial well-being of the retirement fund and the employer even though the benefits are clearly defined/guaranteed.

III) Advantages And Disadvantages Of Defined Benefit Funds

The advantages of a defined benefit fund for a member or employee are the following:

- ☐ The benefits are guaranteed.
- ☐ The contributions are fixed.
- ☐ The employer (not the member) carries the risk of poor investment returns or claims experience.
- ☐ There is a possibility of enhanced benefits if a surplus arises due to a better than expected experience in investments or claims.
- ☐ The fund can be structured to provide better benefits for early leavers or for retrenched staff than are available from defined contribution funds.

The disadvantages of a defined benefit fund for a member or employee are the following:

- ☐ Compared to defined contribution funds, there is usually less flexibility in choosing benefits.
- ☐ The member usually has no choice in selecting the investment portfolio.
- ☐ The risk exists that the employer's financial position may be such that it is unable to increase its contribution when required. This could force the benefits to be cut even if the investment conditions at a macroeconomic level are attractive.
- ☐ It is usually more complicated to understand and to ascertain the "true" value of the benefits in comparison to those provided under defined contribution schemes.

The advantages of defined benefit funds for employers include the following:

- ☐ Employers are able to structure special executive packages to attract staff.
- ☐ Better than expected investment returns and/or claims experience might make this type of scheme less costly than a defined contribution scheme.
- ☐ Employers are able to structure benefits to encourage or discourage retirement, which makes this a useful tool when trying to reduce staff numbers or encourage employees to remain in employment.

The disadvantages of defined benefit funds for employers include the following:

- ☐ Unknown costs per employee make it difficult to budget for contributions.
- ☐ The employer carries practically all the risk in providing for the benefits.
- ☐ The requirement to increase contributions when investment returns are low compounds the risk. This is because the investment returns tend to be poor during times of weakness in the economy, which may also have a negative effect on the employer.
- ☐ The employer might not be able to benefit from accrued surplus if there is pressure to increase benefits based on surplus.
- ☐ Owing to the scheme's more complex nature, administration costs might be higher than under a defined contribution scheme.
- ☐ The complex nature of benefits might mean that members do not fully appreciate the value of their benefits. This would reduce the value of the defined benefit fund in retaining or recruiting staff.

5.2.2 Defined Contribution Fund

I) Benefits

In a defined contribution fund, the retirement benefits are known only on the actual retirement date. The amount of the retirement benefit depends on the contributions made and the investment performance of the fund. The accumulated value of the member's share of the total retirement fund is normally used to purchase a guaranteed pension at the annuity rates available on retirement date, or a living annuity.

A defined contribution fund usually offers some defined benefit-type benefits to the members. A common example is the provision of a death benefit that is fixed as a multiple of annual salary and is usually reinsured with a life assurer. A defined contribution scheme that offers some defined-type retirement benefits is sometimes referred to as a hybrid scheme. However, the term hybrid scheme is also sometimes used to refer to the situation where the employees are members of both a pension and a provident fund.

Owing to the relatively simple nature of the retirement benefits and the outsourcing of other benefits, the administration requirements (and thus the administration costs) tend to be much lower for defined contribution than for defined benefit schemes. However, this might not be the case where members are given investment choice, especially if they can regularly switch between various investment options.

EXAMPLE

Company B's pension fund provides a retirement contribution rate of 7,5% of earning by the employer and 5% of earnings by the employee.

A member earning a salary of R10 000 per month will therefore have the following contributions towards retirement:

Employer contribution: 7,5% X R10 000 = R750 per month

Employee contribution: 5% X R10 000 = R500 per month

Total towards retirement: R750 + R500 = R1 250

II) Contributions

The employee and the employer usually contribute fixed percentages of remuneration into the retirement fund.

The member often has a choice as to the investment strategy applied on contributions, and it is allowed for by offering investment portfolios with different risk–return profiles. It must be remembered that the retirement fund needs to make sure that members are given sufficient information about the available options to make an informed decision. As the benefits on retirement date are highly dependent on the accumulated value of the contributions (and growth thereon) and, if a guaranteed pension is purchased, the rates offered by life assurers on annuity (pension) policies, it is crucial for the members to realise that it is they who carry the investment risk in a defined contribution scheme.

III) Advantages and disadvantages of defined contribution funds

The advantages of defined contribution funds for members or employees include the following:

- The members share directly in good investment returns when they occur. The members can in many cases also choose the nature of the investment portfolio used to accumulate their contributions.
- The contributions are fixed.
- It is usually much easier to understand the benefits and the cost of additional benefits than under a defined benefit fund.
- There is no cross-subsidy between different members if the scheme is operated on a purely defined contribution basis. All members get their contributions plus (net) growth.
- Retirement benefits are usually purchased from insurers. This allows flexibility in choosing the pension product best suited to the needs of a particular member.

The disadvantages of defined contribution funds for members or employees are the following:

- There is no guarantee as to the amount of benefits that the member will receive in the future.
- Members carry the investment risk. This risk is compounded if the portfolio selection allows for aggressive investment portfolios.

- Members also need to purchase a pension from an insurer on retirement. The cost of guaranteed pensions could be high at the time of retirement (i.e. when interest rates are low). This might lead to a lower than expected monthly pension even though the accumulated benefit is in line with expectations.
- Members often fail to appreciate how much more financial planning they have to do under this type of scheme. The most common example of this is that members often underestimate the cost of a monthly lifetime pension and feel overly secure in their financial position until they actually have to purchase the pension on retirement.

The advantages of defined contribution funds for employers may include the following:

- The contributions are fixed, thus less risky than with a defined benefit scheme.
- The structure is simpler and therefore administration costs are lower.
- Defined contribution funds might appeal to younger, more mobile employees, making it easier to recruit such candidates.
- The contribution is usually a fixed percentage of the employee's salary package. This makes it easy to budget for the costs thereof based on payroll.
- Members tend to value their benefits more as they are expressed as a current pot of money rather than a future promise.

The disadvantages of defined contribution funds as far as the employers are concerned may be the following:

- Employers may not make lower contributions in years when investment returns are higher and/or claims experience is better than expected.
- If members have choices in respect of benefits and investment portfolios, the employer may need to spend time and money on ensuring that the board of trustees educates members on the choices available.
- Some members might retire at disadvantageous times, for example when capital values of the accumulated assets are low or when guaranteed pensions are expensive to purchase from insurers. The employer might feel obliged to contribute on an ad hoc basis to maintain goodwill with past and present employees.

Table 5.1: Defined benefit fund versus defined contribution fund

	Defined benefit	**Defined contribution**
The member contributes	A fixed percentage of salary (normally between 5 per cent and 7,5 per cent)	A fixed percentage of salary (normally between 5 per cent and 7,5 per cent)
The company contributes	The amount necessary to provide for the fixed benefit, as advised by the actuary from time to time	A fixed percentage of the employee's salary
Retirement benefit	Fixed benefit, as specified in the fund rules (according to a set formula)	All the contributions plus the net investment return (benefits depend on investment performance) less the cost of risk benefits and administration.
Determination of benefit	Formula based upon: • Final salary or final average salary • Number of years as member of fund • An accrual factor	Member plus employer's total contributions, plus net investment return less costs; the regular pension amount is determined by the product purchased, e.g. annuity rates on retirement date in the case of a guaranteed pension.

	Defined benefit	Defined contribution
Other benefits	Usually also based on formulas and risk, either carried by the retirement fund or reinsured with an insurer	Usually a percentage or multiple of salary and almost always reinsured with an insurer
Administration requirement	Administration intensive, especially if none of the benefits is insured or outsourced	Less complex administration, unless members are given the opportunity to switch investment portfolios on a frequent basis
Risk of investment performance	Carried mainly by the employer	Carried by the member/employee

5.3 PROVIDENT FUNDS

Provident funds are similar to pension funds in that they provide for savings to be made towards retirement.

Before 1 March 2021, members of a provident or provident preservation fund are allowed to take 100% of their retirement benefit as a lump sum on retirement, subject to the applicable taxation on the non-tax-exempt portion. The danger of this is that the unsophisticated or undisciplined retiree may invest poorly or spend the money saved up for retirement and be without an income later in retirement and therefore the changes to legislation with regard to provident funds.

As from 1 March 2021, retirement benefits offered by provident funds changes as follows:

- ☐ The restriction in respect of post-March 2021 contributions will not apply to persons aged 55 or over at 1 March 2021. Such persons will continue to enjoy a full cash lump sum. However, this concession is dependent upon the member remaining in the same provident fund until retirement. Transferring to another provident fund will lead to cancellation of the concession for that member, who will then be treated in the same way as an under age 55 member.
- ☐ For existing provident and provident preservation fund members, all accumulated member interests plus any future growth on those benefits at 28 February 2021 will be given vested rights and will not be impacted by these legislative changes. This means that, at retirement, a member will still be entitled to commute up to 100% of these vested benefits.

Compulsory annuitisation applies to fund balances above R150 000.

I) Benefits

All provident funds are defined benefit funds

II) Contributions

Historically, contributions made by a member to a provident fund did not receive a tax deduction. The employer effectively contributed by means of salary sacrifice arrangements which form part of the negotiations around salary packages. Overall salary is reduced by the amount the member is required to pay, and a lower salary is charged a lower amount of tax. Only the employer can claim a tax deduction for provident fund contributions.

As from 1 March 2021, contributions to a provident fund follow the same structure as define benefit pension funds.

Table 5.2: Features of a pension and provident fund

	Defined benefit	Defined contribution
Administration	Approved by the Commissioner of FSCA and the Commissioner of SARS An agreement between employer and employee must be in place	
Eligibility	All existing employees can join the fund New employees must join the fund	
Retirement benefit	Up to 1/3 can be taken as a lump sum; the balance must be used to purchase an annuity.	Prior to 1 March 2021: Member is entitled to the whole benefit in cash. The fund rules may provide for all or part of the benefit to be paid as a pension From 1 March 2021: Up to 1/3 can be taken as a lump sum; the balance must be used to purchase an annuity.
Member tax deductibility of contributions	27,5% of the higher of taxable income or remuneration. An annual maximum deduction of R350 000 applies.	
Employer tax deductibility of contributions	All contributions made to a taxpayer's retirement funds by the employer is taxed in the hands of the employee as a fringe benefit. The tax payer is entitled to a tax deduction in respect of its own contributions and those contributions made by the employer on the taxpayer's retirement fund.	
Tax-free lump sum at retirement	The first R500 000 less any other lump sum previously received by the member is taxed at 0% R500 001 – R700 000 is taxed at 18% R700 001 – R1 050 000 is taxed at 27% Above R1 050 000 is taxed at R36% Previously disallowed contributions are deductible from the taxable amount.	

5.4 DEFAULT REGULATIONS

The default regulations prescribe the options that a pension fund or provident will default to, should the member not make an individual choice.

The default options must be relatively simple, cost effective and transparent and require the board of trustees to assist members during the accumulation and retirement phases.

5.4.1 Default Investment Portfolios (Regulation 37)

All pension and provident funds with a defined contribution category are required to have a default investment portfolio(s). The investment portfolio(s) that members are defaulted into should be appropriate, reasonably priced, well communicated to members, and offer good value for money. Trustees are required to monitor investment portfolios regularly to ensure continued compliance with these principles and rules. Performance fees will be allowed but subject to a standard to be issued by the FSCA and a regulatory or policy review. Loyalty bonuses are not permitted.

5.4.2 Default Preservation And Portability (Regulation 38)

The rules of a pension and provident funds must allow for default preservation to allow resigning workers to leave their accumulated retirement savings in the fund. The member, however, have the right and option to withdraw, upon request, the accumulated savings or to transfer them to any other fund, thereby achieving portability. Members are required to first seek retirement benefits counselling before they decide.

5.4.3 Annuity Strategy (Regulation 39)

The board of trustees of a pension fund must establish an annuity strategy. Provident funds must only establish and annuity strategy if the fund enables the member to elect an annuity.

Annuity strategy means a strategy, as determined by the board of trustees, setting out the manner in which a member's retirement savings may be applied, with the member's consent, to provide an annuity or annuities by the fund or to purchase an annuity on behalf of the member from an external provider, which annuity or annuities may either be in the name of the member or in the name of the fund and which complies with the requirements and any conditions that may be prescribed from time to time.

In determining the fund's annuity strategy, the board must consider as far as it can reasonably ascertain the following:

- ☐ The level of income that will be payable to retiring members.
- ☐ The investment, inflation and other risks inherent in the income received by retiring members.
- ☐ The level of income protection granted to beneficiaries in the event of death of a member enrolled into the proposed annuity.

The proposed annuity or annuities – which can be a life annuity or a living annuity - must be appropriate and suitable for the specific class of members who will be enrolled into them, must be well communicated and offer good value for money.

Members will be entitled to opt into this annuity strategy by selecting the annuity product in which they wish to enrol (i.e. the member must indicate which annuity product he/she would prefer by opting in instead of opting-out). Members should also be given access to retirement benefit counselling to assist them in understanding and giving effect to the annuity strategy.

With respect to a living annuity, the fund must communicate to members (on a regular basis) the asset class composition of investments, their performance and changes in the income in respect of the annuity. In addition, funds will need to ensure that all fees charged in respect of the proposed annuity are reasonable and competitive considering the benefits provided to members.

The fund must review its annuity strategy at least annually to ensure that the proposed annuity continues to comply with the regulations and is appropriate for members.

5.5 INCLUSIVE OR EXCLUSIVELY COSTED FUNDS

With an inclusively costed fund, all costs associated with operating the fund are deducted from the contributions paid by the employer. With an exclusively costed fund, the employer will pay an additional amount to cover these costs.

There are two variations of inclusively costed schemes:

- Fully inclusive: The administration costs and the cost of the risk benefits provided by the fund are first deducted before any balance is invested for retirement funding purposes.
- Partially inclusive: The deduction may only be for the risk benefit costs or the administration costs and the employer is responsible for the expense that is not deducted.

It is rare that any deductions for risk and administrative expenses are deducted from member contributions, as members would expect a full refund of their contributions on leaving service.

5.6 TAX TREATMENT OF PENSION FUND CONTRIBUTIONS

The success and popularity of retirement funds are largely explained by the tax incentives that the government provides for schemes that operate as retirement funds. These tax concessions make sense for the government as they encourage individuals and their employers to provide for their own benefits rather than depend on the government once they are unable to work due to old age or disability.

To avoid abuse of the tax-free status of retirement funds and the tax-exempt status of contributions, there are limits on how much can be contributed to the fund in any tax year. Any amounts contributed in excess of the limits are treated as taxable income.

A common approach is to treat contributions paid in by individuals and employers as tax deductible (i.e. no tax is payable on income used for contributions). It is also common not to tax the investment income of the retirement fund to avoid double taxation in the event that benefits are taxed, and to provide some incentive to use duly regulated retirement funds instead of other (possibly less regulated) savings vehicles.

5.6.1 Employer Contributions

The employer may deduct unlimited contributions to their employees' pension fund. The contributions made by the employer will, however, be taxed as a fringe benefit in the hands of the employee.

5.6.2 Member Contributions

The individual may deduct contributions to their retirement funds up to 27.5% of the greater of remuneration or taxable income. The 27.5% limit applies to the aggregate of contributions to all funds.

An overall cap of R350 000 will apply on all contributions per annum. The R350 000 cap includes the cost of any risk cover attached to the fund (approved risk benefits).

Contributions over the annual rand limits may be rolled over to future years but will be subject to the limits applicable in those years.

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Only employees can claim the contributions in respect of employer and employee retirement fund contributions. The Employees' Pay As You Go (PAYE) will have to be adjusted to reflect these contributions. Should the employer make these contributions on behalf of the employee, the contributions will have to be neutralised by way of fringe benefits tax charge levied on the employee.

Example

A member earns a salary of R400 000. Her employer contributes R40 000 to her pension fund. The member contributes R30 000 (7.5% to her pension fund. Assume that the full R40 000 contributed by the employer consists of defined contribution components. The member will, therefore, be entitled to a tax deduction equal to 27.5% of the greater of the following: Remuneration: R440 000 or Taxable income: R440 000.

27.5% × R440 000 = R121 000

As the total contribution of R70 000 (the member's amount of R30 000 plus the employer's amount R40 000) is below R121 000, the first test passed.

This figure is also less than the annual monetary cap of R350 000. Thus, the full R70 000 is allowed as a deduction.

5.7 TAX TREATMENT OF BENEFITS

The monthly pension is treated as taxable income, but there is an indirect tax benefit arising from progressive taxation in South Africa. For most members, their pre-retirement income is considerably higher than their post-retirement income. Thus, their tax rate is higher in the years that they contribute and receive a tax break and lower in the years that they receive benefits and pay tax.

5.7.1 On withdrawal

The Income Tax Act makes provision for different types of withdrawal such as the following:

- Deductions from minimum individual reserves in terms of pre-September 2007 divorce orders and post September 2007 divorce orders.
- Cash withdrawals.
- Lump sums transferred to approved funds.

Therefore, when a member resigns from his employment, subject to the rules of the fund he will become entitled to elect one of the following three options in respect of his pension or provident fund:

- A deferred pension, i.e. to leave the benefit in the fund and choose to receive a deferred retirement benefit at normal retirement age.
- Transfer all or some of the benefits to another approved retirement fund.
- Make a cash withdrawal in respect of all or some of the benefits.

We will now examine the income tax implications of each option in greater detail.

I) Deferred Pensions

Where a deferred pension is elected, no tax will be payable until the benefit is paid at normal retirement date.

II) Transfers To Other Approved Retirement Funds

Where benefits are transferred to another approved pension fund, pension preservation fund, provident fund, provident preservation fund or retirement annuity fund, no income tax is payable.

III) Cash Withdrawals

That part of a benefit from a pension fund, provident fund or preservation fund which is taken as a cash benefit, may be subject to income tax.

The first step is to determine the current taxable portion of the withdrawal benefit. This is calculated by taking the amount of the cash withdrawal less any deductions allowed in terms of paragraph 6 of the Second Schedule to the Income Tax Act.

Once the current taxable portion of the withdrawal benefit has been calculated, apply the tax table for withdrawal benefits as published in the Budget Speech each year to the taxable portion of the withdrawal benefit to calculate the income tax payable.

Where the benefit is liable for tax, the administrator must apply to the member's local revenue office for a tax directive, although increasing use is being made of a centralised SARS website system. The tax deduction requested by the revenue authorities may include arrear amounts of normal income tax and, where the member is in arrears with tax payments, an IT88 will be issued for an extra payment to be made over and above the normal tax that will be levied.

Withdrawal benefits are taxed according the to the withdrawal table.

Table 5.3: Withdrawal benefits table

Taxation lump sum	Rate of tax
R0 – R25 000	Lump sum tax free
R25 001 – R660 000	18% of the amount exceeding R25 001
R660 001 – R990 000	R114 300 + 27% of the amount over R660 001
R990 001 and above	R203 400 + 36% of the amount over R990 001

This table is cumulative over a person's lifetime and is applicable to subsequent withdrawal lump sums arising from membership of future funds after 1 March 2014. The taxable lump sum cannot be set off against an assessed loss.

There is also the possibility that a person may withdraw a lump sum from one fund, join another and then retire with a lump sum, join a third fund and withdraw from it with yet another lump sum.

There are many combinations, but where the event is retirement after 1. October 2007, the withdrawal lump sums taken during the members working lifetime will be considered when the tax table for retirement lump sums is applied.

Additionally, the table applies not only to withdrawal benefit, but also to severance package lump sums paid after 1 March 2011.

The accumulation of withdrawal lump-sum benefits as time goes by, as well as and increased tax rates will hopefully to be a powerful incentive to encourage members to preserve their benefits for retirement.

Tax Implications Of Public Sector Funds Upon Withdrawal

Prior to 1 March 1998, lump-sum benefits from public sector pension funds, i.e. state and local authority pension funds, were tax-free. With effect from 1 March 1998, such lump sums are now subject to income tax.

To provide a measure of phase-in relief, Formula C was introduced into the Second Schedule to the Income Tax Act. The idea of Formula C is to only tax that portion of the lump-sum benefit that relates to membership of the fund from 1 March 1998 onwards.

Paragraph 2A of the Second Schedule to the Income Tax Act determines how much of the lump sum is treated as being subject to the normal provisions of the Second Schedule. The amount deemed to be a lump sum subject to the Second Schedule is an amount equal to the amount determined in accordance with Formula C.

Formula C

$$A = \frac{B}{C} X D$$

Where:

A = the amount to be the taxable portion of the lump sum to be included in gross income

B is one of the following:

- Where the number of completed years of employment are in terms of the rules of the fund considered for the purposes of determining the benefits, the number of completed years of employment after 1 March 1998.
- Where the years of employment are not considered in terms of the rules of the fund, the number of completed years of membership of the fund after 1 March 1998.

C = total number of completed years considered in the determination of benefits from the fund.

D = the lump-sum benefit payable to the member.

Public sector fund members can, upon resignation from employment and from the public sector fund, preserve their benefits in a private sector fund.

With effect from 1 March 2006, amendments were introduced to preserve the tax-free status of transferred public sector fund benefits which accrued prior to 1 March 1998.

5.7.2 Payment Of Death Benefit

The full benefit can be taken in cash when a member of a retirement fund dies.

Where the full benefit is not in the form of a cash lump sum, the balance may be used to purchase a compulsory annuity.

Before the benefit can be paid, the administrator must obtain a tax directive.

Lump-sum benefits payable upon the death of a member by a pension fund ora provident fund are taxed in the same way as lump-sum benefits at retirement. For income tax purposes, the lump-sum benefit payable upon the death of a member is deemed to have accrued to the member on the day prior to the member’s death. Therefore, any lump-sum benefit will be taxed in the hands of the deceased estate according to the tax table applicable at retirement, death and retrenchment.

However, any tax payable by the deceased estate may be recovered from the person to whom or in whose favour the lump-sum benefit in question accrues. In practice, any income tax payable is deducted directly from the lump-sum benefit and the net after tax benefit is usually paid to the beneficiary.

If the beneficiary takes an annuity or pension, then the pension or annuity will be fully taxable in the recipient's hands after the death of a member of a pension fund or a provident fund.

Death benefits are taxed according to the retirement/death tax table.

Table 5.4: Retirement/death tax table

Taxation lump sum	Rate of tax
R0 – R500 000	Lump sum tax free
R500 0001 – R700 000	18% of the amount exceeding R500 001
R700 001– R1 050 000	R36 000 + 27% of the amount over R700 001
R1 050 000 and above	R130 500 + 36% of the amount over R1 050 001

Spouses' pensions (and children's pensions, in cases where the pensions are large enough) are taxed as income with monthly deductions in accordance with SITE or PAYE. As the benefit is usually an insured benefit, the insurer who pays the benefit is responsible for the deduction of the tax.

Should the fund insure its own lump-sum death benefits, the administrator (who will be responsible for the payment of the benefit) will have to deduct tax in accordance with normal SITE or PAYE.

5.7.3 Payment Of Disability Benefits

The taxation of disability benefits is complex, as it depends on whether the person affected remains a member of the fund (permanent health insurance) or whether a withdrawal or retirement from the fund takes place (capital disability benefit).

I) Capital Disability Benefit

The other possible disability benefit is the payment of a capital lump sum on permanent disability. In this case, the member leaves the fund either by withdrawal or by retirement. Where a lump sum is payable, the benefit isadded to the normal retirement or withdrawal benefit (as the case may be) for taxation purposes. In some cases, the benefit is payable as an income, in which case it is taxed in the same way as an annuity.

5.7.4 On Retrenchment

A member of a pension fund or a provident fund who is retrenched from his employment may take the full fund value of the pension or provident fund as a cash lump sum.

Taxation Laws Amendment Act amended the Income Tax Act to allow for a tax-free transfer between various retirement funding financial products as from 1 March 2021.

A lump-sum benefit received by the member due to his retrenchment or redundancy will be taxed as a retirement fund lump-sum benefit in terms of the table applicable at retirement, death and retrenchment.

Remember that a severance benefit lump-sum benefit will also be taxed as a retirement fund lump-sum benefit in terms of the table applicable at retirement, death and retrenchment.

5.7.5 Lump Sum Retirement Benefits

If the member has decided to take a part of his benefits in cash, a payment for the appropriate amount will be made after deduction of any tax in accordance with the results of the tax directive application, which has to be made to SARS.

These lump-sum benefits will be taxed according to the retirement/death tax table.

Table 5.5: Retirement/death tax table

Taxation lump sum	Rate of tax
R0 – R500 000	Lump sum tax free
R500 0001 – R700 000	18% of the amount exceeding R500 001
R700 001– R1 050 000	R36 000 + 27% of the amount over R700 001
R1 050 000 and above	R130 500 + 36% of the amount over R1 050 001

As in the case of withdrawal benefits, the table is cumulative over a person's lifetime. So, at retirement SARS assesses all withdrawal benefit lump sums paid before 1 March 2009, together with previous retirement benefits paid after 1 October 2007, as well as any severance packages received after 1 March 2011.

I) Allowable Deductions

The following deductions are allowable according to the Income tax Act:

- ☐ Members' contributions which were previously disallowed as deductions.
- ☐ A withdrawal amount (minimum individual divorce withdrawal) transferred into the fund in terms of an election under Section 37D(4)(b)(ii) of the Pension Funds Act.
- ☐ A withdrawal benefit deemed to have accrued to the taxpayer – only if it has been taxed, e.g. transferred from a pension fund to a provident fund.
- ☐ An amount transferred to a preservation fund as an unclaimed benefit and which was taxed prior to such transfer.
- ☐ An amount transferred from a Government Pension Fund to a private sector fund as represents the tax-free portion, i.e. pre-1 March 1998 pro rata portion.

Any amounts previously deducted cannot be deducted again and the amount of the deductions cannot exceed the lump sum.

After commuting a maximum of up to one-third of the pension or retirement annuity fund capital at retirement, the pensioner is obliged to secure a pension for life with a minimum of two-thirds of the pension or retirement annuity fund capital.

II) Retirement From Public Sector Funds

With one exception, the taxable portion of a cash lump-sum benefit from a public sector pension fund or a public sector provident fund is calculated in the same way as the taxable portion of a lump-sum benefit from a private sector fund at retirement. The same steps are followed when determining the tax-free portion of the cash lump sum from public sector funds, except Formula C of the Second Schedule to the Income Tax Act has to be applied first.

You have previously learnt that the purpose of Formula C is to protect the vested rights of the members of public sector funds accumulated in the fund prior to 1 March 1998. Formula C, therefore, calculates the taxable portion of the lump sum after 1 March 1998.

5.7.6 Monthly Pension Payment

Monthly pension payments are subject to tax if the income from the annuity exceeds the tax threshold. The person making the payment to the pensioner is responsible for the deduction of tax and accounting for it to SARS.

The principle of aggregation will be applied on such monthly pension payment.

5.8 THE PRINCIPLE OF AGGREGATION

In terms of the Taxation Laws Amendment Act of 2009, income tax must be calculated on the aggregate of all retirement fund lump-sum benefits taken previously, i.e. on withdrawal and/or retirement, death and retrenchment benefits (including severance benefits) taken previously.

The steps to be followed when applying the principle of aggregation when calculating the income tax payable on multiple retirement fund lump-sum benefits.

- **Step 1:** Calculate the taxable lump-sum amount of the current retirement fund.
- **Step 2:** Add previously taxable withdrawal / retirement lump sum amounts (After 1 March 2009).
- **Step 3:** Calculate the tax payable on the total amount applying the retirement tax table.
- **Step 4:** Calculate the tax payable on the previously taxable withdrawal / retirement lump-sum amounts. Apply the retirement tax table to arrive at a net taxable amount
- **Step 5:** Calculate the tax payable as the Tax calculate in Step 3 minus the net taxable amount calculated in Step 4.
- **Step 6:** Calculate the taxable lump-sum amount of the current retirement fund.

The following lump sums must be considered for aggregation:

- ☐ **Withdrawal benefits:** All lump-sum withdrawal benefits accrued to the taxpayer since 1 March 2009; previous benefits that were taxed, using the average rate, do not need to be included.
- ☐ **Retirement benefits:** All lump-sum retirement benefits accrued to the taxpayer since 1 October 2007; benefits accrued before that date was taxed using the average rate and do not need to be included.
- ☐ **Severance benefits:** All severance benefits accrued to the taxpayer since 1 March 2011; previous severance benefits that were received prior to this date do not need to be included.

The following portions of lump sums must be considered for aggregation:

- ☐ **Withdrawal benefits:** The taxable portion of the lump sum.

- ☐ **Retirement benefits:** The taxable portion of the lump sum.
- ☐ **Severance benefits:** The taxable portion of the lump sum will in this instance be the full amount of the lump sum.

Example

Lady A retired from her pension fund on 1 October 2009. She received a lump sum amount of R1 million from the pension fund.

Lady A previously retired from her retirement annuity on 1 August 2009 and received a lump-sum amount of R250 000.

The tax payable on the lump sums will be as follows:

Step 1: Calculate the taxable lump-sum amount of the current retirement fund:	R1 000 000
Step 2: Add previously taxable withdrawal / retirement lump sum amounts (After 1 March 2009).	+R250 000 = R1 250 000
Step 3: Calculate the tax payable on the total amount applying the retirement tax table.	R141 750 + 36% of amount above R945 000 = R251 550
Step 4: Calculate the tax payable on the previously taxable withdrawal / retirement lump-sum amounts. Apply the retirement tax table to arrive at a net taxable amount	Up to R315 000: 0%
Step 5: Calculate the tax payable as the Tax calculate in Step 3 minus the net taxable amount calculated in Step 4.	R251 550 – R0
Step 6: Calculate the taxable lump-sum amount of the current retirement fund	= R251 000

Topic 6 Evaluating Retirement Fund Benefits

LEARNING OUTCOMES

After studying the topic, the learner should be able to-

- Evaluate retirement fund benefits.

6.1 INTRODUCTION

The FAIS Act regulates the business of rendering financial services, particularly financial advice, to clients over a large range of financial products. This Act covers ground not regulated by any other legislative measure in the Republic. This is especially so when dealing with the furnishing of advice on the purchase of, or investment in, financial products.

Any person or entity that provides advise in respect of pension fund and/or provident fund benefits need to be authorised by an authorised Financial Services Provider and be registered in terms of Category I: Pension Fund Benefits.

However, advice given by the board of management or a board member of any pension fund organisation to the members, on benefits enjoyed or to be enjoyed by the members, is exempt from the FAIS Act. This specifically relates to a trustee or manager of a company explaining to their staff any changes in their retirement fund.

As most individuals enter into a pension fund or retirement fund through and employer, the representatives' roles in "acquiring" pension fund benefits are limited and the board of trustees have certain obligations regarding informing the members regarding the benefits and any changes. The default regulations also provide that members provide retirement benefits counselling, but this does not include advise. However, representatives can provide individuals with the following services regarding pension and provident funds:

- ☐ Evaluation of retirement fund benefits as part of overall financial planning for individual.
- ☐ Assisting in claiming benefits - current or previously unclaimed.
- ☐ Assisting in transferring fund from a retirement fund.
- ☐ Advising on the best investment profile to be taken for their benefits.
- ☐ Advising on the best investment options on retirement.
- ☐ Advising on the best annuity option on retirement.

This section will only concentrate on the factors to be considered when evaluation a current pension or provident fund of a member in order to provide advise for one of the above-mentioned reasons and do a financial need's analysis.

Benefits consultants that provide services with regard to the structuring of retirement benefits to employers, must also be registered in terms of the FAIS Act as financial services providers. The benefits consulting process is considered in the next topic.

6.2 FACTORS TO BE CONSIDERED

The representatives need to obtain information to understand the structure of the retirement fund and must understand the following:

- ☐ Whether it is a pension or provident fund.
- ☐ Whether it is an umbrella or stand-alone fund.
- ☐ Whether it is a defined contribution or defined benefit fund.
- ☐ Whether the fund is privately administered or insured.
- ☐ The fee structure of the fund.
- ☐ The last date of the actuarial valuation.
- ☐ If the fund is inclusively or exclusively costed in terms of risk benefits and management fees.
- ☐ The investment strategy of the fund and the type of investment portfolio.
- ☐ Whether the investment offer the individual member choice.
- ☐ Who the current investment manager of the fund is?

The above list of information needed are not exhaustive in ascertaining a full need's analysis of a client. The questions may also very, depending on the client's profile.

The representative must also consult the rules of the fund to obtain or verify this information and will provide a very detailed understanding of the current retirement structure.

The representative must also verify the legal status of the fund be requesting copies of the Financial Sector Conduct Authority registration and South African Revenue Service approval certificates. These certificates must be provided for the transfer of any funds from a pension or provident fund.

The representative also needs to consult the fund and benefit policies. The principal policy issued to any retirement fund (excluding a retirement annuity fund) covers the lump-sum death benefits and/or capital disability benefits provided in terms of the fund rules. Where the retirement fund decides to use the services of a life insurer to manage the investments, the life insurer will issue another policy to cover that aspect. Of course, where the retirement fund handles its own investments, there will be contracts with the fund manager(s) that will not be policies. These policies are approved in terms of the Income Tax Act, as they underwrite the benefits promised in the rules of the fund.

6.3 RECORDS OF COMMUNICATION WITH THE CLIENT

In accordance with the FAIS Act, the representative must maintain a record of advice for a minimum of 5 years after cancellation of product or agreement. However, it is advisable to keep all client communications for this time period in the event of any dispute or for referral purposes.

6.4 DISCLOSURES

Representatives need to adhere to the general disclosures as prescribed in the General Code of Conduct – considered in Module 1 (A).

Topic 7 Benefits Consulting

LEARNING OUTCOMES

After studying the topic, the learner should be able to-

- Outline the benefits consulting process.

7.1 INTRODUCTION

Every employee benefit programme including retirement benefits should be integrated into the employment situation, considering salary structures, human resources policies and the employer's approach to industrial relations.

Employee benefit negotiations should not be confused with salary/wage negotiations, although it is inevitable that the two will, in many cases, be seen together.

7.2 EMPLOYEE BENEFITS AS PART OF REMUNERATION PACKAGE

The inclusion of retirement and other employee benefits must be considered a part of the remuneration packages of employees for the following reasons:

- ☐ The government cannot afford worthwhile social benefits for all South Africans. Employees, therefore, look to their employers to provide them with financial support in their times of need.
- ☐ Many of the less sophisticated employees do not understand the need to provide for sickness, disability, death and retirement. On the other hand, the more sophisticated employees have come to regard these benefits as a right in terms of their employment contracts.
- ☐ Insurance and retirement plans are often more cost effective and readily available if they are arranged collectively for a group of people.
- ☐ Current and prospective employees would most likely see the employer with the best group retirement and other employee benefits as the employer of choice.

Notwithstanding this, there is a suggestion that a trend is developing towards employers abandoning what is sometimes seen as a paternalistic approach, forcing retirement savings on employees, in favour of a total cost-to-company package, leaving the individual staff member to decide how to take the benefits. However, the traditional employer-sponsored retirement fund is still the most widely used solution to retirement funding.

It is unlikely that a common set of benefits designed as a single package would be ideal for all. The needs of the employees, and the restricted resources of the employer, mean that a uniquely suitable set of benefits ought to be developed for every employer organisation. Even within the same employer organisation, there could be widely divergent needs among different categories of employees.

A benefit consultant will assist the employer with the consultation process in negotiating retirement fund benefits and other related benefits with the employee. No employee benefit programme will be of any value to the employer or the employees, who are meant to benefit from it, unless it has been designed correctly. For this reason, it is vitally important that the person recommending the structure of the benefit program is well informed and fully up to date with all the latest aspects of benefit design.

7.3 CONSULTATION PROCESS

The benefit consultant assisting in the negotiating process should assess the politics of the situation in which negotiations are to take place and work at gaining the trust of all the parties concerned. Negotiations should be kept focused on the needs and perceptions of the future members, while keeping in mind the financial capabilities of the employer.

All groups of employees should be adequately consulted and represented. In particular, non-union employees should have their own representation. No group of employees should be presented with a situation where there is no room for negotiation.

Hasty and unexpected action should be avoided. An example of such an action would be pressure from the unionised part of the workforce for everyone to join a union sponsored fund rather than the employer's independent fund.

All parties should accept that, where employer and employee representatives have gone through a negotiation process and arrived at an agreed benefit structure, the employer will have discharged his moral obligation, and further employee demands should now wait until the next scheduled round of negotiations.

All the parties to the negotiations should always first be educated as to the complexity of the issues at hand, so that they can understand the issues and make choices based on fact and not on preconceived ideas and misconceptions. In particular, education can narrow the gap between real and perceived needs and thus help negotiations to work toward satisfying real needs. In particular, they should understand the various types of plans, such as pension versus provident fund or underwritten versus self-insured fund, and the implications of tax.

Apart from the training of the negotiating parties, the education of the employee body will be essential if the benefit structure is to be put to a meeting of employees at some stage. It will also enable them to understand, appreciate and use their benefits.

7.3.1 Employer Concerns

Employers, in the main, are profit-orientated individuals or organisations. They aim to earn profits through their particular line of business, so as to provide a return on the capital of their shareholders. Profits are also essential for the financing of the continuation or expansion of the business.

To do so, the employer must provide competitive remuneration packages. However, if he spends too much in this area, the business itself may not be profitable and, if the business does not survive, the employees may end up being the biggest long-term losers of all.

In assessing the cash, perks and employee benefit requirements of staff, the employer needs to consider the salaries, perks and employee benefit arrangements offered by his competitors in the employee market.

7.3.2 Employee Needs

In the previous section, we highlighted the concerns that an employer would need to consider if he wishes to recruit and retain a high-quality workforce.

A constant was the need to consider the wants and needs of the employee. Unless these are identified correctly, no employee benefit program will meet the expectations of the employer as a recruitment and retention tool. The identified employee needs include immediate, short-, medium- and long-term needs.

Both employer and union perceptions of worker needs may be based on, or influenced by, preconceived ideas, prejudices, political and ideological considerations and, therefore, should not be accepted without question.

Establishing real and perceived employee needs may require some form of data gathering. This could be from an independent source or from among existing employees.

I) Factors Influencing Real Needs

The needs of every category of employee are very dependent on factors, such as the following:

- ☐ Levels of skills needed for the job.
- ☐ Educational levels an employee is expected to have.
- ☐ Socio-economic levels from which the employees are recruited.
- ☐ Security of employment provided by the type of occupation.
- ☐ Ethnic or cultural background of the majority of the workforce.
- ☐ Location of the workplace, whether it is an urban or rural setting.
- ☐ Occupational hazards associated with the particular job or industry.
- ☐ Financial circumstances of the individual employees.
- ☐ Nature of the work, such as the demands it makes on the employees.

Most employee benefit arrangements provide benefits, based on categories rather than an individual basis. This is often for ease of equity, administration, and to comply with regulatory requirements.

However, it must not be forgotten that benefits are payable to individual employees or their nominees, and that these individuals will have widely varying needs. These needs depend on how the factors mentioned above affect the individual.

There are other factors, such as ongoing expenses, outstanding debt, and especially the employee's age and number of dependants that must be considered.

It is also important to establish whether the employees' needs are already being met, or about to be met, by other plans. Examples of these would be industry- specific programmes set up in terms of labour legislation or benefits provided by a trade union to its members.

II) Real And Perceived Needs

There may be a wide gap between the real and perceived needs of the employee. This is often the result of false impressions created by social and environmental circumstances, and which are made worse by poor numeric and literacy skills.

While an employee benefit programme aims to meet real needs, it would be a serious mistake not to take the perceived needs and wants of the employees into account if members are to accept the fund. The perceived needs and wants of an employee group will be influenced by their views of the factors mentioned in the previous section, as well as their belief and value system.

Here are two examples of how the needs and perceptions of different groups can vary:

- Many South Africans are poorly educated and skilled as a result of past inequalities. This has resulted in a large unemployment problem and, where these people are employed, low-skilled, manual employment opportunities. These people have needs of an immediate nature, such as food, clothing or housing.
- Those who do manage to find work know that their jobs are often only temporary or seasonal, and have concerns about retrenchment, redundancy, or even dismissal. As their work is usually of a manual nature, they are also in fear of losing the ability to continue working, either due to illness, injury or advanced age.

These concerns obscure the need for retirement provision, which therefore becomes a factor only when retirement is imminent.

Traditionally, white-collar workers have felt much more secure in their jobs and, therefore, have been much more open to making timeous provision for their retirement and other possible eventualities.

In the changing South Africa of today, the security of this group is also under threat and many are being forced to seek some immediate benefits at the expense of future options, simply to enable them to keep to their previous standards of living.

Because individual needs, both real and perceived, vary so greatly, a decision needs to be made about the level of benefits that should be aimed at in a fund.

One of the following options can be chosen:

- Meeting the lowest level of need, thus putting the onus on the employees to top up to the required level by means of individual provision
- Meeting the highest level of need, so that all have adequate provision, and many eventually have far more than is needed
- Somewhere between the two, such as using a middle-of-the-road approach.

The level of benefits to be provided must consider the ability of both the employer and the employee to pay for them. It must also be realised that needs and perceptions change over the years. Therefore, what is adequate or balanced now, may not be in the future.

7.4 OBTAIN AND INTERPRET QUOTATION

The basis of obtaining quotes would be to first determine whether the fund is going to be administered by an insurer or privately administered either by the sponsoring company itself or by a specialist pension administration manager.

When a fund is to be administered by an insurer, quotations will be requested from a number of competing insurers on all or certain services to the fund.

Privately administered funds operated by the sponsoring employer itself would normally request quotations only for the risk benefits from insurers. In the case of a privately administered fund to be administered by a specialist pensions administration manager, quotations would be required for the costs of administrative services to be rendered in addition to quotations from insurers for the risk benefits

To provide a quotation, insurers and specialist private administration managers would need to know:

- ☐ Type of fund
- ☐ Umbrella or standalone
- ☐ Inclusive or exclusively costed fund
- ☐ Employer and employee contribution levels
- ☐ Normal retirement age

7.5 PROPOSAL

It is essential that a comparative report be presented to the employer by the benefits consultant. This report should include the following:

- ☐ Executive summary
- ☐ Background to the reason for the proposal being presented
- ☐ A comparison between the existing benefits the client may have, if any, and the new proposed plan. Due regard must be given to the implications of the following.
  - Retirement benefits.
  - Administration issues and costs.
  - Investment administration and costs.
- ☐ Summary of recommendations proposed.

It is imperative that the proposed written report ensure that all the needs identified in the financial needs' analysis are addressed.

7.6 RECORD KEEPING

The benefit consultant should ensure that a full record of the discussion and any paperwork are carefully preserved in accordance with regulatory requirements. Such matters would include the following:

- ☐ Financial needs analysis done
- ☐ Disclosures made
- ☐ Quotes received and analysed
- ☐ Recommendations made.

The documentation will prove invaluable to the client and the consultant as a record of the negotiations and as proof of what was agreed in the event of a dispute in the future.

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Topic 8 Payment Of Benefits

LEARNING OUTCOMES

After studying the topic, the learner should be able to-

- Understand the payment of benefits under all circumstances.

8.1 INTRODUCTION

When benefit claims arise, the employer is responsible for informing the administrator of the claim.

As part of the claim process, the relevant documentation will be submitted by the employer to the administrator.

The administrator will access the validity of the claim. The employer's notification of the claim is accepted in good faith. In some cases, the claims are straightforward and can be paid easily, with reference to the rules of the fund. Other claims are more complex and require discretion to be exercised by the board of trustees or the administrator.

The administrator will be responsible for paying the claims in terms of the rules of the fund, taking the necessary income tax implications into account and making the necessary payments over to SARS.

8.2 WHEN ARE BENEFITS PAYABLE?

A member of a retirement fund may generally become entitled to its benefits in the following circumstances:

- ☐ Resignation
- ☐ Dismissal
- ☐ Death
- ☐ Retirement
- ☐ Disability
- ☐ Liquidation / partial termination of fund
- ☐ Divorce

8.3 WITHDRAWAL OF BENEFITS

Subject to the rules of the fund, an employee has the following choices upon withdrawal from a pension or provident fund:

- ☐ Transfer the withdrawal benefit to the new employer's pension or provident fund – if new funds allow for it.
- ☐ Transfer the withdrawal benefit to a retirement annuity fund.
- ☐ Take the withdrawal benefit in cash.
- ☐ Leave the benefit in the fund and choose to receive a deferred retirement benefit at normal retirement age.
- ☐ Transfer a portion of the withdrawal benefit to a retirement annuity fund and take the balance in cash.

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- ☐ Transfer the withdrawal benefit to a preservation fund.
- ☐ Take a portion of the withdrawal benefit in cash and transfer the balance of the withdrawal benefit to a preservation fund.

If the cash withdrawal benefit is transferred to another fund or preservation fund, then the ability to access the benefit before retirement will disappear and taxation can be completely avoided.

Withdrawal claims are the most common, and the rules of the retirement fund may set out provisions for the payment of different benefits. It is the administrator's duty to ensure that the correct type of benefit is established before payments are processed.

The Pension Funds Act was amended in 2001 to introduce the concept of minimum benefits. Historically, up to that point, many funds only refunded members' own contributions on leaving service, with the employer's contributions falling back into the fund to swell the fund for the benefit of the remaining members. Clearly, that could be unfair, particularly to members with long service who find themselves retrenched, near retirement and only their own contributions to fall back on.

So, the amended law makes provision, in simple terms, for the member who is leaving service through normal resignation, dismissal or retrenchment to receive not only a refund of his own contributions, but also the full benefit of the employer contributions, as well as all the investment growth on both. Similar provisions apply on transfers to other funds, conversions and fund terminations.

In a defined contribution fund, the term minimum benefits mean that the member is entitled to the full asset value build-up at the time of leaving. The position in defined benefit funds is vastly more complex and the fund valuator has to make a calculation based on guidelines from the Financial Sector Conduct Authority.

The same principles may apply to a privately administered defined contribution fund where, for example, the members do not share fully and directly in the investment growth from year to year as the valuator tries to smooth the returns.

In addition, in a defined benefit fund (and a privately administered fund for that matter), where the fund pays the pension rather than purchasing an annuity from an insurer, the fund has to formulate a policy on post-retirement pension increases.

8.4 DEATH CLAIMS

The level of benefits payable to an active member of a retirement fund who dies will be defined in the rules of the fund.

There may be benefits payable in addition to the retirement savings. The additional benefit may be in the form of a pension payable to a spouse (or spouses) and minor children. Additional death benefits are, however, most commonly set up as a lump-sum benefit, for example, a death benefit equal to 2 times the member's annual salary at death. If these additional lump-sum benefits are provided through the fund, i.e. they are included in the rules of the fund, all the benefits must be distributed in terms of provisions of Section 1 and Section 37C of the Pension Funds Act. Tax may be payable on these benefits.

8.4.1 Admission Of Claims: Death In Service

If a member dies before retirement, the benefit in terms of the rules of the scheme is calculated on the latest salary details. Before admitting the claim, certain documents must first be produced, and certain investigations conducted.

In the event of a death claim, the insurers will require that the administrators provide proof of death in the form of an official death certificate. Proof of age will also be called for if this has not yet been submitted. If death occurred very soon after commencement of membership, the insurer may also ask the administrator to confirm that the member was in active fulltime employment on the date the member became eligible to join the scheme.

8.4.2 Equitable Distribution Of Death Benefits

It is generally accepted that benefits will be paid to a dependant. However, not every member has clearly defined dependants. The member may never have married, be divorced, be a widow or widower, and/or die childless.

A member may also nominate a person who is not a dependant, but who he would like to receive a portion of the death benefit in the event of the death of the member. This person is called a nominated beneficiaries (nominee).

Section 37C places the disposition (allocation and payment) of a member's death benefit under the control of the fund's board of trustees. The trustees have discretion regarding the application of the death benefit to the member's dependants or nominated beneficiaries in such proportions as they deem equitable (fair), based on the results of their research and investigation into the deceased member's personal circumstances and due consideration of the needs of the beneficiaries and dependants. The fund has a period of 12 months within which to trace any dependants of the member and then make the appropriate allocation.

In the event of a member's death, the trustees will first examine the member's Nomination of Beneficiary form (an expression of wish on how the member would like his death benefits to be distributed). This form is usually a good indication of the member's personal status with regard to dependants and will assist the trustees in expediting the distribution of death benefits. The trustees' final decision on disposition of the benefits must be based, however, on thorough research and they cannot simply follow the nomination of beneficiary form.

I) Distribution: Dependants Only Or Dependants And Nominees

As mentioned, the trustees are required to exercise their discretion and decide on an equitable distribution under any circumstances where there are dependants involved. Only where the member leaves no dependants is the discretion of the trustees not required. The circumstances under which the trustees must exercise their discretion are the following:

- ☐ **Dependants only:** If the trustees become aware of, or are able to trace, dependants of the member within 12 months of the member's death, they must distribute the benefit to those dependants in a manner they deem equitable.
- ☐ **Dependants and non-dependent nominees:** If the member had nominated non-dependent beneficiaries and also left dependants, the board must within 12 months of the member's death distribute the benefit to the dependants and non-dependent nominees in a manner they deem equitable. It should be noted that, in this case, the trustees can decide on the portion (if any) to be allocated to a non - dependent nominee.

II) Distribution: No Dependants, Only Non-Dependent Nominees

If the trustees do not become aware of or are unable to trace any dependants of the member within 12 months of the member's death, and the member had nominated non-dependent persons as his beneficiaries, the benefit must be distributed according to the nomination form in the proportions selected by the member. However, the trustees may only do so once the amount by which the debts of the member's estate exceeds the assets in the estate, has been settled.

III) Distribution: No Dependants And No Non-Dependent Nominees

If the trustees do not become aware of, or are unable to trace any dependants of the member within 12 months of the member's death, and the member had not nominated non-dependent persons as his beneficiaries or, if he had only nominated non-dependent persons to receive a portion of the benefit and a portion remains, the benefit (or the balance thereof, as the case may be) must be paid to the member's estate. If no inventory of the member's estate had been registered by the Master of the High Court, the benefit must be paid to the Guardian's Fund.

8.4.3 Factors To Consider When Distributing Death Benefits

When the trustees are required to decide on an equitable distribution of the benefit to the dependants and non-dependent nominees of a member, they should consider all relevant facts, and ignore those that are irrelevant. The Pension Funds Adjudicator has identified some facts, which will be regarded as relevant to the apportionment of a benefit. These are generally referred to as the basket of factors to consider in the apportionment of a benefit. Some of these factors are considered in the subsection following.

I) The Amount Of The Benefit Available For Distribution

First and foremost, the trustees should consider the amount they are dealing with. A benefit of R500 will certainly not require the same level of investigation and circumspection as a benefit of R1 million.

II) Extent Of Dependency

The trustees should consider the extent to which each dependant had relied on the deceased for financial maintenance and, in doing so, consider the current and future maintenance needs of the beneficiary. Sometimes dependants will base their claim for dependency on trivial occasional amounts made available by the deceased on odd occasions, such a bus fares for visiting the deceased and grocery donations once in a while. Such claims do not often amount to financial dependency.

III) Age

A young child will naturally be more dependent on the member for maintenance than an adult child, as the minor child is unable to work and will require maintenance for purposes of daily living expenses, education and medical expenses until he reaches the age of majority.

IV) Current Income And Qualifications

The income, job and qualifications of a potential beneficiary must be compared to the income, job and qualifications of the other beneficiaries. A beneficiary who is qualified as an attorney will not be as dependent as a beneficiary who has a Grade 8 qualification.

V) Benefits Received From Other Sources

The trustees should take into consideration other benefits paid to a claimant on the death of the deceased, for example, individual life insurance policies or in terms of the Will of the deceased. If, for example, one out of three of the deceased's dependants had been sole heir to his estate, the trustees should consider awarding the remaining two dependants a greater share of the fund benefit.

VI) Future Earning Potential

A beneficiary who is well qualified will have a greater chance of securing employment than a beneficiary with little or no academic qualifications, skills or experience. Remember, age or any form of disability will also play a role in respect of this factor, namely that a person past general retirement age or a person suffering from ill health will not have the same future earning potential as a healthy, young beneficiary who has just qualified to enter a certain job.

VII) Relationship With The Deceased

Did the deceased and the claimant have a close relationship? Did they live together? This can be established from affidavits by relatives and colleagues, as well as from the beneficiary nomination form or the deceased's Will.

VIII) Wishes Of The Deceased

Despite what has been stated above about the role of the beneficiary nomination form, the wishes of the deceased, as reflected on the nomination form, should be considered by the trustees, as the member would ultimately have known which persons had been most reliant on him for maintenance.

8.4.4 Manner Of Payment Of Benefit

Once the trustees have decided on the apportionment of the benefit, they are required to decide on the most appropriate method of payment to each beneficiary.

The default method of payment is to pay a benefit directly to the beneficiary. However, in many cases this is not possible because the beneficiary has limited legal capacity; for example, if the beneficiary is a minor, or if he is an adult with limited mental or other legal capacity. In such cases, a benefit should generally be paid to the parent (in the case of a minor) or the custodian (for example in the case of an adult with limited mental capacity) of the beneficiary.

Up until November 2008, the Pension Funds Act allowed for alternative methods of payment by way of payment to a trust contemplated in the Trust Property Control Act and payment from the fund by way of instalments. However, certain developments in the industry (such as the ongoing Fidentia debacle) led to concerns that beneficiaries' interests might not be adequately protected.

The change to Section 37 C (2) also introduced the establishment of beneficiary funds which are only permitted to take lump-sum payments in respect of minor dependants or major dependants, who are incapable of managing their own affairs and, in return, to pay beneficiaries, These trusts are considered in the subsections following.

I) Payment To The Guardian Or Caregiver Of The Beneficiary.

Payment of a benefit from a fund may be made to a person recognised in law (which includes the Child Care Act) or appointed by a Court as the person responsible for managing the affairs or meeting the daily care needs of the beneficiary. When one considers the provisions of the Child Care Act, such a person could include not only a biological parent or court-appointed legal guardian, but also a person who takes care of the child on a daily basis (what we would previously have referred to as the custodian of the child). What this essentially means for purposes of Section 37C of the Pension Funds Act, is that payment of a benefit may be made to any of the following:

- ☐ A natural parent.
- ☐ A guardian appointed by a court.
- ☐ A factual caregiver of a child.

II) Payment Into Trust

As stated above, payment into trust was possible prior to November 2008, but certain concerns of the Regulator have led to further restrictions being imposed on these payments. The requirements for payment into trust are now that:

- ☐ The trust must be registered in terms of the Trust Property Control Act, 1988
- ☐ The trust must have been or be selected by any of the following persons:
  - The member
  - The guardian or caregiver of a beneficiary
  - The beneficiary, if he/she is an adult person with full legal capacity.

III) Payment To A Beneficiary Fund

As a result of the Regulator's concerns about the protection of beneficiaries' benefits, provision has now been made for funds to be established specifically for purposes of the protection of death benefit beneficiaries' benefits, referred to as beneficiary funds and which funds are to be regulated in terms of the Pension Funds Act. The Pension Funds Act sets out no requirements for benefits to be paid to such funds. It is, therefore, presumed that the fact that such funds will be regulated under the same provisions of the act applicable to other retirement funds, will be regarded as sufficient to protect beneficiaries' benefits.

IV) Payment From The Fund In Instalments

A less popular option is payment from the fund in instalments. The reason why this option is used less frequently than the others, is that the fund retains its liability towards the beneficiaries until the instalments cease. Section 37C (3) makes provision for payment of instalments in respect of minor beneficiaries and Section 37C (4) for instalments in respect of adult beneficiaries.

V) Payments To Minors

Section 37C (3) determines that interest, at a reasonable rate, having regard to the actual fund return earned by the fund, must be added to the outstanding balance of the benefit. Furthermore, the outstanding balance must be paid to the beneficiary in full when he/she reaches the age of majority.

VI) Payments To Adult Beneficiaries

Payment in instalments to an adult beneficiary may only be made with the consent of the beneficiary in terms of a written agreement, in which the amount and frequency of payments and other terms and conditions must be included. The agreement may be cancelled by either party by giving 90 days' notice in writing to the other party, after which the outstanding balance of the benefit must be paid to the beneficiary in full.

8.5 DISABILITY CLAIMS

Very few funds these days offer true disability benefits. These benefits are usually offered through a separate insurance arrangement. The rules of a fund must specify the action to be taken in the event of a member becoming disabled. The following options on disability are most typical in retirement fund rules:

- ☐ In a defined benefit pension fund arrangement, the rules may include a clause on ill health early retirement. The retirement formula will then be applied with an adjustment, and the member will receive a reduced pension from the fund if all the disability criteria have been met. Practice does vary, however, and in some cases the disability pension may be based not only on accrued service to the date of disability but make take service not yet served up to normal retirement age into account.
- ☐ In a defined contribution arrangement, there may be no additional provision made within the fund or in a separate arrangement. In this case, the member who is disabled will cease to be a member and will be paid the current value of his share of the fund.
- ☐ In either a defined benefit or defined contribution fund, the rules may refer to the separate disability arrangement. If this arrangement is payable in the form of a monthly income, the disabled member may remain an active contributing member of the fund. If the separate arrangement has been set up as a lump-sum payment in the event of total and permanent disablement, the fund rules usually state that the member ceases to be a member of the fund, and the value of the benefit should be paid out. In the event of disablement, the claims process is far more complex.

8.5.1 Admission Of Disability Claims

Information must be called for from the disabled member, his medical doctor and the employer. On the strength of this information provided by the administrator, the insurer must judge if the degree of disablement is sufficient to qualify for payment of the benefit in terms of the definitions of disablement contained in the rules.

Where large lump sums are involved and the qualifying condition is permanent disablement, the insurer may want to postpone a decision in order to test the permanence of the condition. This postponement is normally written into the rules and can be a stipulated period from the date of disablement.

Should there still be some doubt as to the permanence of the disablement, some insurers reserve the right, in terms of their policy conditions, to pay the benefit in 60 equal instalments over a period of five years.

8.6 RETIREMENT BENEFIT CLAIMS

The main purpose of a pension or provident fund is obviously to make provision for retirement savings. The benefit at retirement will be defined in the rules ofa fund and includes provisions for early, normal and late retirement. The rules will state the fund's normal retirement age; for example, age 65. The benefits will depend on whether the fund is a defined benefit fund, in which case the benefit will be calculated in terms of the fund rule's formula, or a defined contribution fund, in which case the benefit will be equal to the member's current retirement savings value, also known as a fund credit, or share of fund.

The amount that the member can withdraw as a cash lump sum will depend on whether the fund is a pension fund or a provident fund:

With a pension fund, the member can take one third in cash.

With a provident fund, members that were over the age 55 on 1 March 2019 can take all of the benefits in cash. For members that were under the age of 55 on 1 March 2019, only the contributions and return on the investment earned before 1 March 2019 can be taken as cash. Contributions and return on the investment earned after 1 March 2019 is subject to the one third rule.

Benefits taken from a fund are always subject to tax.

The rules of a pension fund may offer a member either the choice of becoming a pensioner of the fund or buying an annuity from an insurer. Where a member has the option of becoming a pensioner of the fund, annual pension increases are granted at the discretion of the trustees, taking the advice of the fund's actuary into account.

These days the majority of funds do not offer members the option of becoming a pensioner of the fund; the retiree must buy his own annuity from an insurer. Even where there is a choice of becoming a pensioner of a fund or buying an annuity outside the fund, most retirees these days opt for buying an annuity from an insurer.

8.7 IMPACT OF DIVORCE ORDERS

The State regards pension assets as special assets worthy of enhanced protection. Pension benefits are not reducible, transferable or executable, except in the limited instances outlined in the Pension Funds Act and certain other Acts of Parliament. One of the exceptions to this general rule is the payment of a pension benefit to a former non-member spouse in terms of a divorce order issued by the High Court. Before we look at executing the payment of pension benefits, it is important to understand the background to the current situation as the treatment of pension benefits as part of a divorce order changed in September 2007.

8.7.1 Position Prior To September 2007

Prior to the amendment of the Divorce Act of 1979 by the Divorce Amendment Act of 1989, a spouse's interest in benefits, which had not yet accrued, was generally not regarded as an asset in his/her estate, or as an asset in the joint estate, if married in community of property. This meant that the pension interest of a member spouse was not considered when dividing assets on divorce.

The Divorce Amendment Act of 1989 changed this situation. It introduced an amendment to Section 7(7)(a) of the Divorce Act according to which a member spouse's pension interest is deemed to be an asset in his/her estate for purposes of determining benefits in the event of a divorce. It allowed the court granting a divorce in terms of the Divorce Act, in dealing with pension interests, to make an order that-

- ☐ Any part of the pension interest of the member, which is due or assigned to the other party to the divorce action, shall be paid by the fund to the other party when any pension benefits accrue in respect of that member.
- ☐ An endorsement be made in the records of the fund that this part of the pension interest concerned is payable to the other party.

Pension interest: Definitions as per the Divorce Amendment Act, 1989

Pension interest in pension and provident funds is a member's withdrawal benefits in terms of the rules of the fund if membership would have terminated on date of divorce on account of a member's resignation.

The pension interest in the retirement annuity fund is the member's contribution up to the date of the divorce, plus interest.

From the definition, it is clear that no allowance was made for interest and/or growth to be added to the pension interest. Thus, if the pension interest was determined as the specific value as at the date of divorce, and the benefit was eventually only paid by the fund ten, twenty or thirty years later when the member left the service, the non-member spouse received no interest or positive growth for that period. Moreover, the assigned/transferred benefit could only be paid to the non-member spouse when the pension benefit accrued to the member.

Another problem was that, if the non-member spouse died before accrual of the benefit, it was not payable into his/her estate.

Consequently, the Office of the Pension Funds Adjudicator received numerous complaints concerning divorce benefits prior to 13 September 2007, mostly regarding the definition of pension interest.

The Pensions Fund Amendment Act, 2007 which came into operation on 13 September 2007, introduced major changes with regard to the effect of divorce orders on retirement benefits.

8.7.2 Position with effect from September 2007

The Pension Funds Amendment Act, which came into operation on 13 September 2007 created a radical shift regarding the payment of divorce benefits. The fund is now entitled to deduct from the member's benefit or his minimum individual reserve, any amount assigned from his pension interest to a non-member spouse according to a divorce order in terms of Section 37D(1)(d) of the Pension Funds Act.

The pension benefit payable to the principal member is now deemed to accrue to the member on the date of the court order in terms of Section 7(8) of the Divorce Act. It can now be divided at the time of the divorce and payment can be made to the non-member spouse immediately. This is often referred to as the clean-break approach (that is, a clean and final division of the pension benefit on the date of divorce).

The meaning of pension interest on divorce has been amended with effect from 1 November 2008. Pension interest in terms of a pension fund (other than a retirement annuity fund) is now defined as the fund value at the date of divorce. (No growth after the date of the divorce is included.)

In terms Section 37D(1)(e) of the Pension Funds Act, the deduction shall be affected by the pension fund named in the court order upon receipt of the order, and the deduction shall have the effect of reducing the accrued benefit at the date of the deduction. In terms of the new Section 37D (4) (2008 legislation), disregarding any previous arrangement, the amount allocated will immediately be deducted from the member’s benefit, as well as tax on it.

The non-member spouse has the option to receive the award in cash or transfer this amount to an approved retirement fund. The fund must pay or transfer the gross amount allocated in the divorce order within 60 days of being informed.

If no election is made during the 120-day period, the fund must pay the relevant amount within 30 days of the expiry of this period in cash to the non-member spouse.

The failure to transfer within this period shall result in the fund being liable for late payment interest at the fund return rate.

Another aspect that had caused great confusion was which party to the divorce was responsible for the tax on the amount paid to the non-member spouse. After the implementation of the amendment to the Divorce Act in 1989, the member spouse paid the tax and the non-member spouse received a tax-free benefit. The tax was paid as an additional deduction from the member spouse’s fund value, so that party suffered a double deduction. The member spouse could proceed against the non-member spouse for recovery of the tax, but in the circumstances few did. It was possible to avoid the problem by allowing for the payment of tax in the divorce order, but the fact was not widely appreciated and the idea of returning to court to vary the divorce order at a time of strain was distinctly unpalatable to both parties.

The position was partly rectified. With effect from March 2012, the position was further refined for post 13 September 2007 divorce orders payable after March 2012. The member spouse had no tax liability, and the non-member spouse assumed that liability in his/her personal capacity. If, the non-member spouse elected to preserve the gross amount of the benefit, then no tax would be levied at that point.

8.8 IMPACT OF THE MAINTENANCE ACT ON BENEFIT PAYMENTS

Pension benefits are regarded as extraordinary assets which enjoy additional protection. However, the law allows certain deductions to be made from the pension benefit in terms of Section 37D of the Pension Funds Act. One of these deductions is maintenance claims.

Maintenance obligations are imposed by the law on certain parties, depending on the nature of the relationship between them. For example, the common law imposes a duty of support on the part of the parent to maintain a child or the law of marriage imposes a reciprocal duty of support on the spouses. The extent of the support is often captured in a court order, outlining the amount and manner of payment.

From a pension fund point of view, there are two types of maintenance claims, namely arrear maintenance and future maintenance.

8.8.1 Arrear Maintenance

This type of claim refers to a situation where a person has obtained a court order in respect of maintenance. Hereafter, the pension fund member fails to comply with the order and is in arrears with the maintenance payments. In such an instance, the maintenance creditor can request the fund to deduct the arrear amounts from the pension benefit payable upon the termination of the employment contract.

8.8.2 Future Maintenance

This claim also applies in respect of a maintenance court order where the member is not necessarily in arrears, but there is a possibility that he may not pay in future in terms of the order.

Two High Court rulings have created an avenue to secure future maintenance needs. Thus, maintenance beneficiaries must be aware of the requirement outlined by the courts and, where they suspect that a pension fund member may default on payment, they can approach the fund and request a withholding of the benefit to secure a claim.

8.9 INSOLVENCY AND BENEFIT PAYMENTS

The disposition of retirement benefits in the event of insolvency is provided for in Section 37B of the Pension Funds Act. In case of the sequestration of the estate of any person, who is entitled to a benefit payable in terms of the rules of the fund, the benefit will not be deemed to form part of the assets in the insolvent estate of that person, and may not in any way be attached or appropriated by the trustees in his insolvent estate or by his creditors, notwithstanding anything to the contrary in any law relating to insolvency.

8.10 HOME LOANS AND BENEFIT PAYMENTS

Section 37D makes provision for certain deductions, which may be made from retirement benefits when they become due.

Before dealing with the mechanics of home loans, it is important to understand exactly what home loans can be granted by a retirement fund. Retirement annuity funds do not generally become involved in-home loans, as there is no mechanism for reclaiming the amount on default before the member actually retires.

Pension and provident funds can become involved in housing/home loans inone of two ways:

- ☐ By a direct loan from the fund assets. These days, very few funds take this route and generally only self-administered funds have the capacity and flexibility to do so. There is a considerable amount of extra administration and record-keeping, and few funds have the expertise to operate what is essentially a building society operation.
- ☐ The almost universal practice is to outsource the function to a bank or building society and the fund provides only a guarantee that funds will be made available to settle any outstanding loan on default, death withdrawal or retirement. The bank/building society will normally charge a rate of interest linked to prime.

Funds are very cautious as to the amount they lend or provide a guarantee for. The starting point is usually the amount payable to the member on withdrawal, and then allowance is made for the potential tax payable. There is also the possibility of the member getting divorced in the future or some order made under the Maintenance Act. As far as payment is concerned, all of this would take priority over a housing loan. So, often the amount lent or guaranteed might be as low as 20% to 30% of the withdrawal value.

Policing of housing loans is another factor, which makes many funds reluctant to grant housing loans or guarantees. Often funds made available for housing loans were not used for that purpose at all, but for settling all manner of debt.

8.10.1 Retirement

Where a housing loan has not been settled by the time of a member's retirement, the deduction allowed is restricted to the cash commutation value. This means that, while all the money from a provident fund can be claimed (prior to March 2019), only the third commutation allowed in terms of pension fund rules would be available.

8.10.2 Withdrawal

Where a member withdraws from a fund, while still owing money on a housing loan and the benefit is a cash lump sum, the whole of the benefit may be claimed to repay the housing loan.

Where the member is transferring his whole benefit to another fund, which is prepared to accept the responsibility for the loan, no deduction is made.

Where the receiving fund is not prepared to accept responsibility, the housing loan must be repaid, and only the balance of the withdrawal benefit transferred.

8.10.3 Death

The position on death is identical to that where a withdrawing member takes a cash lump sum.

Further, should a member default on his home loan, and no viable solution can be found, the trustees have the authority to use the member's withdrawal benefit to pay back the loan as a last resort.

8.11 SERVICE PROVIDER REQUIREMENTS FOR CLAIMS

When a claim is made against a risk benefit of a pension fund, it is important to consider the required documentation to be submitted to the service provider.

Often claims are not resolved quickly due to the lack or incompleteness of documentation.

Once the documentation is submitted, it may be necessary for the service provider to investigate to confirm the validity and nature of the claim.

Each insurer has its own requirements for such claim processes. It is, therefore, necessary for the representative to be fully informed of the required processes and documentation.

8.11.1 Claims Record-Keeping Requirements

All claims records need to be kept for audit purposes, and then for five years thereafter as a prescription period.

8.11.2 Member Communication Regarding Claims Processes And Payments

It is prudent business practice to ensure that members, dependants, pensioners and deferred pensioners are kept in constant communication about the claims they have made, and the processes involved in finalising those claims.

8.11.3 Communication To Pensioners, Deferred Members And Dependants Of Deceased Members

Communication between funds and their members was improved by setting minimum disclosure requirements to which all funds had to adhere. So too, minimum standards of communication were set for dormant members of the fund.

Many long-established funds will have a large number of pensioners who will no longer be actively contributing to the fund. These pensioners will be receiving their pensions and, provided the payments arrive at regular intervals, will have very little or no need to communicate with the administrator of the fund. Among those who are receiving a benefit, may also be the surviving spouse or minor dependants of a member who died before he reached normal retirement age.

A further category of dormant member will be the deferred member. A deferred member is a former employee of the employer who has chosen not to withdraw his accumulated retirement benefits from the fund. These benefits will thus remain within the fund until the normal retirement age of the former employee, at which stage he will be entitled to become a pensioner of the fund.

The minimum disclosure requirement for communication with members other than active was set out in PF circular number 90. PF 90 must be read and understood in conjunction with circular PF 86, as it constitutes an extension thereof.

While Circular PF 90 clearly sets out the minimum standards, which are to be adopted, the format of disclosure is not prescribed and may be done in any manner. It is, however, imperative that the disclosure is in writing and clear, unambiguous and in plain language. Disclosure may be made in any one or more of the official languages of this country, having regard to the composition of the membership and the needs of the members.

Retirement funds are also encouraged to have periodic meetings with pensioners and dependants where they can express concerns, ask questions and participate in the governance of the fund.

The following general information must be kept up to date and sent to the retired member, deferred pensioner or dependant, who is in receipt of a benefit on an annual basis:

- Full names of the retirement fund.
- The type of fund.
- The registered address of the retirement fund and the name of the principal officer.
- The reference number for the retirement fund.
- The name and address of the administrator (if applicable).
- The names of the trustees.

- ☐ The name and job title of the contact person at the retirement fund, or the administrator who will be available to answer queries and that person's telephone number, facsimile number, e-mail address and, if that person's address is different from that of the retirement fund or administrator, that person's address.
- ☐ The procedure to be followed in the event of an enquiry, a complaint or a dispute resolution, should any arise. Reference should be made to the administrator.
- ☐ A request to notify the contact person, in writing where applicable, of any change in name, address, banking details or any other circumstances that are likely to affect the pensioner's, deferred pensioner's or dependant's membership of, or benefits in the fund.
- ☐ A request that the fund be informed, in writing where applicable, of the choice of the method of payment; for example, whether by cheque posted by registered mail, or by electronic transfer. A statement should be made on who carries the risk in each case if the payment does not reach the pensioner, deferred pensioner or dependant, as the case may be.
- ☐ Advice that the rules, annual financial statements and actuarial valuation of the fund, if applicable, may be inspected at the registered address of the retirement fund.
- ☐ Advice that members have the right to elect 50% of the board members and that the procedure for members to exercise this right is set out in the rules of the fund or, if the retirement fund has been exempted from the requirement of having an elected board, advice to that effect.
- ☐ Brief information on policy relating to the governance of the retirement fund, investments, etc.
- ☐ A request, where applicable, that a nomination in respect of benefits be made.

8.11.4 Initial Disclosure

In addition to the general information, the following minimum information must also be disclosed to pensioners on their retirement, to deferred pensioners when they cease to be active members, and to dependants of deceased members at the time of the death of the member and the recognition of the rights of the dependants.

I) To Pensioners

The following minimum information must be disclosed to pensioners on their retirement:

- ☐ A request that the initial disclosure be retained for future reference since all annual disclosures must be read in conjunction with the initial disclosure and previous annual disclosures.
- ☐ The pensioner's full names.
- ☐ The date of retirement.
- ☐ A confirmation of how the gross amount of any retirement benefit was calculated, and an indication of what was exercised by the pensioner regarding commutation, if applicable, and the details of any deductions that may be made.
- ☐ The date and frequency of pension payments.
- ☐ Any conditions applicable to the payment of the pension (for example, guaranteed period, suspension of the pension, or the cessation of the pension).
- ☐ Whether the pension will be subject to increases and, if so, the policy of the retirement fund regarding pension increases. The fund may stress that the amount of the increases is not guaranteed and may point out the factors, which will influence the increases.
- ☐ Periodical requirements (for example, a certificate of proof of existence) and the effects of non-compliance.

- ☐ Whether any other benefits are payable by the retirement fund (for example, medical benefits) and the circumstances under which they are payable.
- ☐ Whether other benefits (for example, spouse's pension, children's pension or death benefits) are payable on the death of the pensioner.
- ☐ Whether the pension is an untied annuity, purchased from a life insurer or a pension from the fund, and the implications of each option.

II) To Deferred Pensioners

The following minimum information must be disclosed to deferred pensioners when they ceased to be active members:

- ☐ A request that the initial disclosure be retained for future reference, since all annual disclosures must be read in conjunction with the initial disclosure and previous annual disclosures.
- ☐ The deferred pensioner's full names.
- ☐ The date on which active membership of the fund ceased.
- ☐ A statement on whether the deferred member may, at any time, withdraw from membership and, if so, how the withdrawal benefit will be calculated.
- ☐ A description of how a death benefit or an ill-health benefit before retirement, if any, will be calculated.
- ☐ The policy of the retirement fund regarding growth fund entitlement during deferment. The fund may stress that such growth is not guaranteed, and may point out the factors, which influence such growth.
- ☐ A synopsis of which benefits the deferred pensioner will receive on retirement.
- ☐ Whether the pension, upon retirement, will be subject to increases and, if so, the policy of the retirement fund regarding pension increases.
- ☐ Whether other benefits (for example, a spouse's pension, a child's pension or a guaranteed pension) are payable on death after retirement.
- ☐ Whether the pension at retirement will be an untied annuity purchased from a life insurer or a pension from the fund, and the implications of each option.

III) To Dependants

The following minimum information must be disclosed to dependants of deceased members at the time of the death of the member:

- ☐ A request that the initial disclosure be retained for future reference, since all annual disclosures must be read in conjunction with the initial disclosure and previous annual disclosures.
- ☐ The deceased member's full names and date of death.
- ☐ The dependant's full names.
- ☐ A summary of all benefits that were payable on death, what has already been paid, and what will be allocated towards the payment of the dependant's pension. A confirmation of how the gross amount of pension was calculated must also be provided.
- ☐ The gross amount of each payment and the details of any deductions that may be made.
- ☐ The date and frequency of payments.
- ☐ Conditions applicable to the payment; for example, a guaranteed period, suspension or cessation.

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- ☐ Whether the payment will be subject to increases and, if so, the policy of the retirement fund regarding increases. The fund may stress that the amount of the increases is not guaranteed and may point out the factors that will influence increases.
- ☐ Special requirements, for example, a copy of the birth certificate or identity document, or proof of continued qualification, and the effects of non-compliance.
- ☐ Whether any other benefits are payable by the retirement fund, for example, medical benefits and the circumstances under which they are payable.
- ☐ Whether the pension is an untied annuity purchased from a life insurer or a pension from the fund, and the implications of each option.

Topic 9 Member Communications

LEARNING OUTCOMES

After studying the topic, the learner should be able to-

- Name the rights of members of a retirement fund.
- Outline the minimum communication requirements to members.
- Name the process for the notification of special events.
- Define the annual and special disclosure to be made.

9.1 RIGHTS OF THE MEMBER

Section 7D (1) (d) of the Pension Funds Act provides that the Board of Trustees must ensure the adequate and appropriate communication of information to the members of the retirement fund. In conjunction with the Act, Circular PF130 also deals with communication and access to information in the discussion of Principle 9: Communication and Access to Information.

Any member may request that the fund provide him, subject to the payment of a prescribed fee, with a copy of the following:

- ☐ Rules of the fund
- ☐ Latest revenue account.
- ☐ Latest Statement of Financial Position.

Any member is entitled to inspect, without a charge, at the registered office of the fund, and may make extracts from the following documents:

- ☐ Rules of the fund.
- ☐ Latest revenue account.
- ☐ Latest Statement of Financial Position.
- ☐ Latest report (if any) prepared by a valuator.
- ☐ Latest statement (if any), report on this prepared and submitted to the Commissioner of the Financial Sector Conduct Authority where a valuation has, in the opinion of the Commissioner, been deemed unnecessary.
- ☐ Latest statement and report submitted to the Commissioner of the Financial Sector Conduct Authority which has been prepared at his insistence because the fund is deemed to be in an unsound financial position.

Where a concerned member is still not satisfied after having had access to the documentation mentioned herein, he can approach and attempt to persuade the Financial Sector Conduct Authority to order an inspection in terms of the Inspection of Financial Institutions Act.

9.2 MINIMUM COMMUNICATION REQUIREMENTS

Following extensive consultation and substantial agreement with representatives of the retirement fund industry, it was decided to improve communication between funds and their members by setting minimum disclosure requirements to which all funds had to adhere. These minimum disclosure requirements were set out in Circular PF 86.

Every new member must be provided with an explanatory pamphlet within three 3 of his date of admission to the fund. An annual benefit statement must be given to every member within 6 months after the financial year-end of the fund. In the case of an underwritten retirement annuity fund, the issuing of a policy document/certificate of membership that contains all the necessary information is considered to be adequate and thus replaces the explanatory pamphlet.

Both documents may be in any format but must be fund specific and contain the information considered in the subsection following. The pamphlet must make it clear that an employee is able to refer to the rules if he requires further information.

9.2.1 Details Of The Fund

The following details regarding the fund must be provided:

- The fund name and its registered address.
- The name and job title of the person who can be contacted to answer queries, together with that person's relevant telephone numbers.
- The fund's reference number.

9.2.2 Details Of Benefits

The following information regarding the benefits must be provided:

- ☐ The member's name (plus class of membership, if applicable).
- ☐ The member's date of birth.
- ☐ The member's date of admission to the fund and date of effective membership if different (This may happen where, for example, the member's service is backdated.)
- ☐ The pensionable salary of the member at the date of the statement.
- ☐ The date of the statement, as well as the date of the calculation of the benefits.
- ☐ A statement of the benefits that become payable at relevant instances.
- ☐ The value of any benefit payable on death.
- ☐ The value of any early retirement benefit payable as a result of disability or ill health.
- ☐ The value of any withdrawal benefit should the member withdraw within the current year.
- ☐ The value of any retirement benefit with the following information:
  - The normal retirement date.
  - For a defined benefit fund, the anticipated benefit based on current salary.
  - For a defined contribution fund, a statement of how the benefit is structured, with an explanation of investment risk.
  - For a defined benefit fund, a statement that a reduced benefit becomes payable on early retirement.

- If the rules provide for fixed pension increases, this should be stated.

9.2.3 Rate Of Contributions

The following information regarding the rate of contributions must be provided:

- ☐ Current contributions payable by the member and the frequency thereof.
- ☐ Current contributions payable by the employer and the frequency thereof. In the case of a defined contribution fund, this should be the actual amount with an indication of whether management and risk benefit costs are included or not. In the case of a defined benefit fund, a statement that the employer's contributions are the balance of cost will be sufficient.
- ☐ Where the calculation of a member's interest is dependent on market values, an explanation that the market risk may affect the benefit levels must be given.
- ☐ Where there are additional benefits as a result of a transfer or transfers from previous funds, these must be identified separately.

9.2.4 General

The following additional information must be provided:

- ☐ A statement that the rules, financial returns and the most recent actuarial valuation report may be inspected at the registered office of the fund or at the main office of the employer. Should a member want any copies, he may be asked to pay for them if this is a requirement set out in the rules of the fund.
- ☐ The procedures for internal dispute resolution and access to the Pension Funds Adjudicator.
- ☐ A note stressing the importance of nominating a beneficiary and keeping any nomination up to date.
- ☐ A statement that it is important to obtain professional advice, before electing a benefit on termination of membership.
- ☐ A statement to the effect that, if the benefit statement conflicts with the rules, the rules will prevail.
- ☐ A statement to the effect that all benefits may be subject to income tax, depending on the tax regime in place at the time.

9.2.5 Additional information

Funds that wish to provide members with additional information in excess of the required minimum, may do so.

Other matters of which members may be informed, and which may or may not be included in the scheme booklet, are as follows:

- ☐ Details of how to apply for membership and how evidence of acceptance as a member is issued.
- ☐ An outline of any provisions for the exercise of discretion by the management board in relation to benefits. In particular, where the management board has discretion to decide who should receive benefits on death, it is beneficial to explain the reason for this provision, and to describe any arrangements whereby the member can indicate his preference as to a beneficiary.
- ☐ How benefits are taxed, including:
  - Taxation of lump-sum benefits.
  - Tax treatment of refunds of contributions on withdrawal or death.

- Estate duty position in relation to death benefits.
- Treatment of employees' contributions to a pension fund are deductible from taxable income and that relief is given by deducting contributions from pay before the tax liability is calculated.

- ☐ In general terms, how contributions are invested.
- ☐ Provisions in the event of winding up, including priority of rights and the principles governing the disposal of any surplus assets.
- ☐ It is good practice for funds to include information on the additional unapproved benefits where they are in a position to do so.

9.3 NOTIFICATION TO MEMBERS OF SPECIFIC EVENTS

Notification to members must be given to members in the following special events and are considered in the subsection following:

- ☐ Fund restructuring
- ☐ Withdrawal from service
- ☐ Retirement
- ☐ Deferred benefit
- ☐ Death

9.3.1 Fund Restructuring

Fund restructuring includes the following events:

- ☐ Voluntary termination of the fund in terms of Section 28 of the Pension Funds Act.
- ☐ Withdrawal of an employer (this will not apply where the fund is an umbrella fund with unrelated employers).
- ☐ Conversion from a defined benefit to a defined contribution fund.
- ☐ Reduction or increase in benefits or contributions.
- ☐ Transfer of benefits to another fund.

The information on conversions should consist of a personal benefit statement, illustrating the effect of the conversion, stressing the difference in benefit structure and the resulting transference of investment risk.

Where the funds are to be transferred, in terms of Section 14 of the Pension Funds Act, the statement should include a note of the transfer value and the actual document must be supplied by the transferor fund. Reasonable notice, not less than 60 days, is to be given to the members of the intention to restructure the fund to allow time for objections.

9.3.2 Withdrawal From Service

All the options in terms of the rules should preferably be explained to every member before he decides to take a cash payment. As a final fail-safe mechanism, the letter enclosing any cash payment must refer to any benefits that may have been forfeited as a result of selecting the cash payment option. Any facility for the payment of a transfer value should be explained.

Special mention must also be made of the fact that no income tax liability is incurred if the proceeds are transferred to another pension fund, preservation pension fund or a retirement annuity fund.

9.3.3 Retirement

A notification explaining the available options in terms of the rules of the fund must be sent to the member before he actually retires. Where the benefit is to be paid in the form of an annuity, the member must be warned that he will be required to produce a certificate of existence from time to time.

In the case of a provident fund, the member will have the option to receive the total value of the benefit available as a single lump sum (if above the age of 55 as on a 1 March 2019). In this case, the notification must clearly indicate that the payment will be the full and final benefit payable from the fund, and that no further payments will be made in the future.

9.3.4 Deferred Benefit

In the case of a deferred benefit (for example, a preserved pension on withdrawal before retirement in the fund), written information should be provided on how this should be claimed when it becomes due.

9.3.5 Death

In the event of the death of a member before retirement, the trustees of the fund will need to decide to whom the benefit(s) will be payable. Appointment of a nominated beneficiary by the member before his death will be considered, but the trustees must look to the needs of dependants who may not have been appointed, and who may have a valid claim. This is especially so if the nominated beneficiary is not a dependant. The trustees are bound to act in accordance with Section 37C of the Pension Funds Act.

The dependants or beneficiaries who are to share in the benefit must each receive a letter notifying them of the decisions made by the trustees and setting out the options available. Where the benefit is to be paid in the form of an annuity, the dependant or beneficiary must be warned that the same conditions as those for retirement from the fund will apply.

9.4 ANNUAL DISCLOSURES

In addition to the general information, the following information must also be disclosed to pensioners and dependants of deceased members on an annual basis:

- ☐ The date of the annual disclosure.
- ☐ A statement that the annual disclosure must be read together with the initial disclosure and the previous annual disclosures, and that it updates the initial disclosure and the previous annual disclosures.
- ☐ Details of any variations or amendments that may have occurred in the general information or initial disclosure since the date of the previous annual disclosure.

9.5 SPECIAL DISCLOSURES

Special disclosures must be made to all pensioners, deferred pensioners and dependants before the happening of a special event. A special event will include, for example, the following:

- ☐ A change of address of the retirement fund or its administrator.
- ☐ The restructuring of a fund.
- ☐ A transfer to or from a fund.

- ☐ Any rule amendment that is likely to affect the membership or benefits of the pensioner, deferred pensioner, or dependant in any way.

A special disclosure must, as a minimum requirement, include the following information:

- ☐ The date of the special disclosure.
- ☐ A statement that the special disclosure must be read with the initial disclosure and, if applicable, all previous annual disclosures, and that it updates them.
- ☐ The details of the special event and the effect, if any, it will have on the pensioner, deferred pensioner or dependant.
- ☐ Any action that may be taken, or recourse that is available, if the pensioner, deferred pensioner or dependant is dissatisfied with, or aggrieved by, the special event.

9.6 MEMBERSHIP COMMUNICATION PLAN

There are two types of communication that take place regarding a pension fund. First is the formal communication, as set out above, and the second is communication from the employer to the employees regarding the fund.

When a fund plans a communication programme, the first item to be addressed is to agree with the trustees and the employer about the objectives of the programme and to whom it is addressed. The objectives should be simple, clear and preferably measurable.

Such objectives will be different for each fund but can be for one of the following reasons:

- ☐ To inform all employees of their total benefits, all their components and their value to the member and his dependants.
- ☐ To inform all members of the amount of money the employer spends on benefits.
- ☐ To educate members on the methods of maximising the income tax and estate duty relief.
- ☐ To encourage employees to recognise the necessity for additional life cover and retirement provision.

When deciding on the medium, the following list of communication strategies may be considered:

- ☐ Audio-visuals
- ☐ Explanatory meetings
- ☐ Explanatory booklets
- ☐ Individual benefit statements
- ☐ Announcement letters
- ☐ Displays
- ☐ Annual reports
- ☐ In-house magazines
- ☐ Computer terminals
- ☐ TV advertisements